ARTICLE – New players on the mortgage market

The Swedish mortgage market is undergoing some important changes. Loan brokers have gained increasing significance by helping mortgage borrowers to cut their borrowing costs, and non-bank lenders are competing with traditional banks for mortgage customers. The mortgage volumes these new players are managing are currently small, both in relation to the total annual flow and the outstanding volume. However, experiences from other countries suggests that these new players may become important players on the mortgage market. This could be positive for financial stability, for example if they use more stable funding sources than the banks. However, the new business models have not been tested in a declining mortgage market, which could entail new risks. New players could also complicate macro-prudential policy. It is therefore important that all future mortgages, regardless of lender, are subject to a thorough credit assessment and covered by current and future relevant macroprudential regulation.

The Swedish mortgage market

The Swedish mortgage stock is significant in relation to GDP (about 70 per cent) and mortgage lending to households amounts to about SEK 3,120 billion.[66] Mortgage lending in Sweden is primarily conducted by banks[67] which typically hold mortgages on their balance sheets. The mortgage market is concentrated and the four major banks account for 75 per cent of the total lending. The market is characterised by a high share of variable interest rate mortgages and a low level of credit losses.

To fund mortgage lending, banks mainly issue covered bonds which are typically bought by domestic and foreign investors such as insurance companies or pension funds. The size of the covered bond market is about SEK 2,160 billion and the average maturity of newly-issued bonds is five years.[68] As mortgage loans are rarely paid back fully, the current mortgage market embodies significant structural liquidity risks, something that the Riksbank has highlighted previously.[69]

New players on the mortgage market

Recently, a number of new players have appeared on the Swedish mortgage market. These players are either loan brokers that connect borrowers with lenders or non-bank lenders that grant mortgages to create and manage investment products on the behalf of institutional investors.

Loan brokers match borrowers with lenders

The first type of new player, loan brokers, match borrowers with lenders and vice versa. For borrowers, loan brokers provide an effective way of cutting mortgage costs. This is typically done via online services that allow borrowers to compare their existing borrowing costs with alternative offers and to exchange their existing loans for more favourable ones. Lenders can use loan brokers to grow their mortgage businesses in a cost-effective manner. By screening various borrowers and making a first assessment of their creditworthiness, loan brokers provide lenders with access to a large pool of potential borrowers.

In Sweden, loan brokers that focus on mortgages is a relatively recent phenomenon. There are currently 39 loan brokers in Sweden, of which seven are specialised in mortgage loans.[70] The amount of mortgages intermediated by loan brokers is still small, but it is increasing rapidly. According to market surveys, mortgage brokers intermediated mortgages to a value of about SEK 20-25 billion in 2017.

Non-banks create investment products from mortgages

The second type of new player on the mortgage market is non-banks that grant mortgages with the aim of creating and managing investments on the behalf of institutional investors. A typical non-banking player has two different parts: one that issues mortgages and one that creates and manages investment products (see Figure A:1). The part of the business that grants mortgage loans does so under the

[66] Data from the end of 2017.
[67] The banks issue mortgages directly or via their wholly-owned mortgage institutions. Both banks and mortgage institutions operate under the Banking and Financing Business Act (2004:297), which means they must comply with special banking requirements related to capital, liquidity and funding.
[68] The average maturity of the outstanding stock of covered bonds is three years. Data from the end of 2017. See statistics from the Association of Swedish Covered Bond Issuers.
[69] For an in-depth description of structural liquidity risks, see *Financial Stability Report* 2016:2. Sveriges Riksbank.
[70] This categorisation is based on licences registered in FI's business register.

Mortgage Business Act (2016:1024).[71] According to this Act, the lender may conduct mortgage lending without having a formal banking licence and without being subject to bank-like capital, liquidity and funding requirements. The lender normally follows its own internal credit terms, such as a maximum loan-to-value ratio, for the mortgages to qualify for a certain investment product. The lender works closely with an internal or independent loan broker to gain access to a large range of mortgages that fulfil the internal credit terms. To begin with, the loans are held on the lender's balance sheet. They are then sold on to investors in the form of various investment products.

An example of such an investment product is an investment fund that invests in mortgages with a certain credit quality. This mortgage fund buys mortgages from lenders and funds the purchase by issuing securities.[72] Those who invest in the securities, insurance companies and pension funds for example, receive a flow of income from the underlying mortgages and are therefore directly exposed to the mortgages. The holders of the securities hence bear the full credit risk stemming from the underlying mortgages. The fund manager normally charges a fee for its services. Such a fee is normally deducted from the interest income before it disbursed to investors.

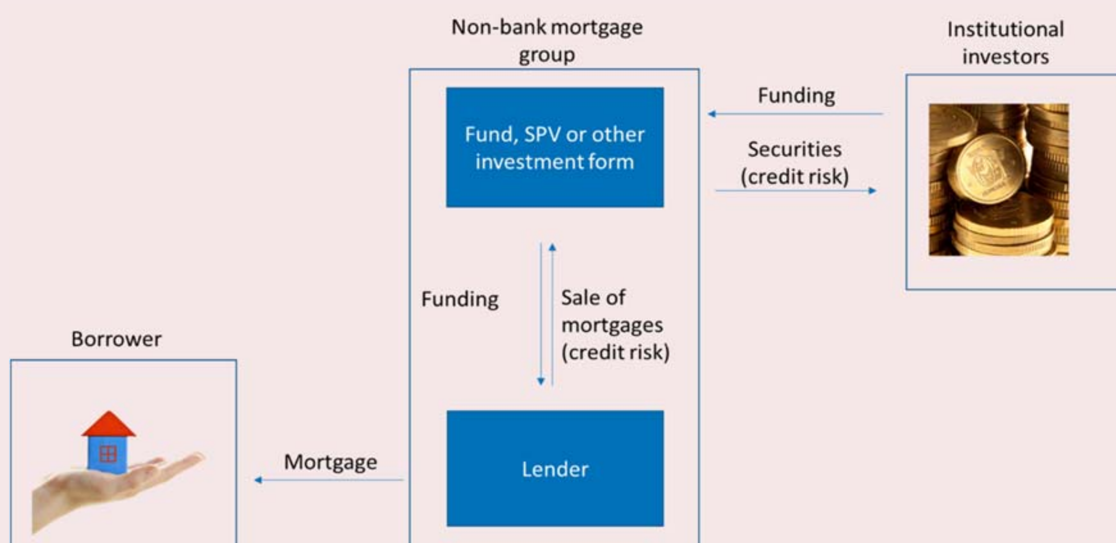
Another type of investment product can be created by securitising mortgages. The mortgage portfolio is then sold to a Special Purpose Vehicle (SPV). The SPV in turn issues bonds to fund the purchase of mortgages.[73] The bonds use mortgages as collateral.[74] Even in this case, the credit risk is borne by those investing in the bond.

In Sweden, the first non-bank mortgage players started their mortgage operations at the end of 2017. There are currently fewer than five players on the market and their mortgage volumes so far have been small in relation to the total annual flow and outstanding volume.

Common phenomenon in the Netherlands

Insurance companies and pension funds in the Netherlands have been active on the mortgage market for a long time.[75] After the financial crisis, banks reduced their supply of mortgages while insurance companies and pension funds wanted to increase their exposure to mortgages. This led to the establishment of the first investment funds with mortgages as collateral. Via direct lending, and with the help of these funds, insurance companies and pension funds doubled their exposure to household mortgages. At the end of 2016, they made up about 11 per cent of the total outstanding volume of mortgages in the Netherlands.

Figure A:1. Illustrative structure of a non-bank mortgage company



Source: The Riksbank

[71] The Mortgage Business Act is the Swedish implementation of the EU Directive 2014/17/EU that regulates residential mortgage lending by banks and non-bank institutions in the European Union.

[72] Such securities can be designed as fixed income securities with an economic profile similar to fund shares. The nominal value of these securities and interest payments would in this case depend on the economic performance of the fund, as is the case for fund shares. Since these securities would also have a maturity, the fund would need to buy back these securities when they expire.

[73] Eliasson, E. Rydén, A. (2014) Securitisation – background, new developments and possible consequences, *Economic Commentaries* No. 10. Sveriges Riksbank.

[74] Mortgage-backed securities (MBS).

[75] Loan markets in motion. Larger role of pension funds and insurers boosts financial stability, 2016. De Nederlandsche Bank.

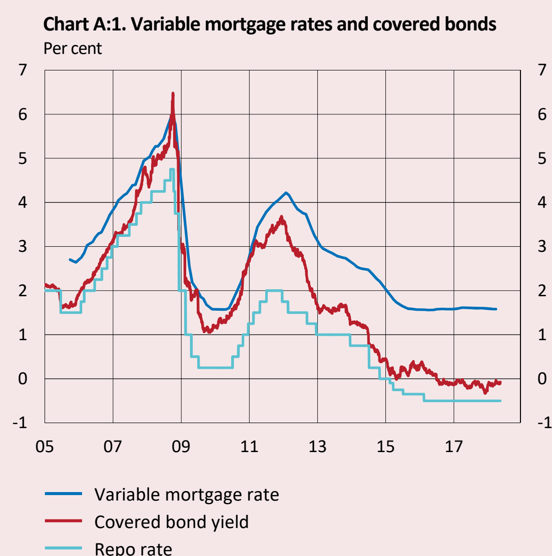
Factors that drive the emergence of new players

There are several reasons why new players have entered the Swedish mortgage market. One reason is that direct exposure to mortgages offers investors attractive returns, especially in relation to other comparable assets, such as covered bonds (see Chart A:1). The average variable interest rate for outstanding mortgages is currently about 1.6 per cent, for example. This can be compared with yields on covered bonds, which are currently close to zero. The extra yield that investments in mortgages offer over covered bonds reflects in part a higher risk for credit losses and worsened liquidity. But it also reflects banks' increased mortgage margins after the financial crisis.[76]

The increased demand for mortgages from institutional investors may also be a consequence of recent changes in certain regulations. Mortgages are now treated more favourably than covered bonds when calculating the capital requirements of certain types of insurance companies, making them particularly attractive for insurance company investors.[77]

Chart A:1. Variable mortgage rates and covered bonds

Per cent



Note. Mortgage rate is based on outstanding mortgages. Yields refer to covered bonds with five-year maturities and variable coupons.

Sources: Statistics Sweden and the Riksbank

Digitalisation is another driver behind the recent changes on the mortgage market. In Sweden, competition on the mortgage market has been weak for a long time.[78] This has, to a high degree, affected customers, who have found it time-consuming and troublesome to negotiate with different loan providers. Loan brokers have used digitalisation to drastically reduce the search and negotiation costs for borrowers, and have created greater transparency and competition on the market. More mobile customers have helped the growth of smaller but more competitive banks as well as facilitated the entry of non-bank lenders. Digitalisation has also led to lower costs for lending, which has reduced the disadvantage that smaller players previously had in relation to larger players due to economies of scale.

Another important factor that has facilitated changes on the mortgage market is that mortgages are a standardised product. Credit risk assessment for mortgages has been standardised and, to a greater extent, automatised and banks no longer have the unique advantage of screening and monitoring borrowers via their bank accounts. Access to "big data" in combination with efficient use of information has instead led to a competitive edge for technically advanced players. The handling of non-performing mortgages is also becoming increasingly standardised and non-bank lenders can use specialised debt collection firms for this purpose.

Finally, the implementation of certain legislative changes has also facilitated the entry of non-bank lenders into the mortgage market. The Mortgage Business Act (2016:1024) has made it easier for different players to conduct mortgage lending without the need to have a traditional bank license. This has lowered the entry barriers to the mortgage market, since these players do not have to comply with the same regulations as banks.

Financial stability implications

Greater competition leads to lower debt-servicing costs

The increasingly prominent role of loan brokers in combination with the entry of non-bank mortgage lenders will increase competition on the mortgage market. Increased competition is likely to lead to lower mortgage rates, especially for those borrowers that pay relatively high interest rates in relation to their creditworthiness. Lower mortgage rates reduce borrowers' debt servicing costs and increase their ability to repay existing debt. Lower mortgage rates can also increase the demand for new mortgages, leading to increased indebtedness. How much the borrower is allowed to borrow, however, is also determined by the borrower's income and other credit conditions.

[76] Stricter capital requirements together with low and falling risk-free interest rates in the post crisis period entailed lower returns on equity for the banks. Banks managed lowered profitability, at least partially, by increasing their mortgage margins. See for instance The banks' margins on mortgages, fourth quarter 2017. Finansinspektionen.

[77] Under the Solvency II delegated regulation (2015/35), a low LTV mortgage (below 60 per cent) is favourably treated compared to covered bonds when calculating the insurance company´s capital ratio.

[78] Weak competition on the Swedish mortgage market is among other things reflected in an abnormally high share of borrowers paying listed interest rates (see Under Siege, 2016. *SEB Equity Research*).

Lower profits and potentially longer interest-rate fixation periods

Lower mortgage rates also lead to somewhat lower profits for the existing mortgage lenders, all other factors being equal. For instance, a fall in mortgage rates by 10 basis points may reduce major banks' net profits by 2 to 4 per cent, depending on how much of their total lending is made up of Swedish mortgages. While lower profits typically worsen the ability of banks to withstand adverse shocks, abnormally high profits due to low competition is an ineffective measure to promote financial stability.[79] Therefore, somewhat lower but more sustainable profits from mortgage lending should not jeopardise financial stability.[80]

In the Netherlands, there has been downward pressure on mortgage rates, particularly within segments with longer interest-rate fixation periods, which can partly be linked to new players on the mortgage market.[81] If interest rates fall in such a segment, it may reduce the high proportion of variable-rate mortgages, thereby making households less sensitive to unexpected rate rises.

Lower concentration risks, more diversified supply of mortgages and potentially lower refinancing risks

Greater competition can also lead to lower concentration on the mortgage market. Currently, the four largest banking groups control about 75 per cent of the mortgage market. Loan brokers help smaller mortgage providers to grow faster than the existing larger players. This leads to a reduction in concentration and could give the four major banks a less dominant role in the long term.

Non-bank lenders also complement banks' supply of mortgages and lead to a transition from a bank-oriented mortgage system to a more market-based system, which in turn leads to the credit risk being directly borne by investors instead of by the banks' owners. An additional source of funding can also make the supply of mortgages more resilient, reducing the risk of a credit crunch.

A more market-based mortgage funding with long maturities would also reduce structural liquidity risks on the mortgage market. Non-bank lenders issue mortgages on behalf of institutional investors such as insurance companies and pension funds. These investors are typically interested in long-term investments, which make them suitable for mortgage funding. Banks issue covered bonds with the average issuance maturity of five years, while some non-bank lenders use funding instruments with ten-year maturity.

New non-standardised business models can create new risks and complicate macroprudential policy

At the same time as the new players can be expected to have a certain positive effect on financial stability, they also bring new risks and challenges. These new non-bank business models are currently non-standardised. Credit terms, as well as the maturity and design of funding instruments, can vary across different players, and change over time. It is therefore possible that some of these new players may start competing with less favourable under-writing standards or create products that increase rather than decrease liquidity risks in the system.

Neither have the new business models been tested in a declining mortgage market. It remains to be seen how these new players manage downturns when the number of non-performing mortgages can potentially increase dramatically. The risk exists that these businesses will be less able to manage a large number of non-performing mortgage loans than traditional banks with experience of economic downturns. It also remains to be seen how they cope with periods in which institutional investors' willing-ness to invest in mortgage loans decreases rapidly. In such a scenario, mortgages already issued by lenders but not yet sold on to institutional investors need to be dis-invested with unfavourable terms, for example in the form of a fire sale. This can lead to a credit crunch or create other stability risks. Neither do these players have the same access to a central bank's liquidity facilities as banks do.

Finally, it should be mentioned that non-bank lenders are currently not covered by macroprudential policy measures, such as the amortisation requirement, which apply to banks as mortgage issuers. However, FI has referred a proposal to expand the scope of application for the amortisation regulations to cover companies licensed to issue mortgage loans in accordance with the Mortgage Business Act.[82] It is important that all future mortgages are subject to a thorough credit assessment and are covered by current and forthcoming relevant macro-prudential policy regulations, and not just mortgages issued by credit institutions that are covered by the Banking and Financing Business Act (2004:297).

[79] A large share of these profits is typically paid out to shareholders via dividends and share buybacks. Furthermore, there are other more effective ways to safeguard financial stability, such as capital requirements, for instance.

[80] The relationship between competition and financial stability is probably non-linear. According to empirical research, a move from low competition to an intermediate level of competition can be considered as stability enhancing. However, after a certain point, an increase in competition will result in excessive competition, undermining financial stability. For more information, see for instance Vives, X. Competition and Stability in Banking. *Princeton University Press*.

[81] Loan markets in motion. Larger role of pension funds and insurers boosts financial stability, 2016. De Nederlandsche Bank

[82] Proposals: Regulations on amendments to FFFS 2016:16 on the amortisation of loans with housing as collateral. Finansinspektionen.