FJÁRMÁLAEFTIRLITIÐ
THE FINANCIAL SUPERVISORY AUTHORITY, ICELAND

Rules on maximum loan-to-value ratios for residential mortgages

Memorandum

July 2017

FME issues rules on maximum loan-to-value ratios

Fjármálaeftirlitið (FME) has issued rules limiting the loan-to-value ratio of new residential mortgages in accordance with Article 25(1) of Act No. 118/2016 on Consumer Mortgages. In accordance with the Rules entering into force, the maximum loan-to-value ratio will be 85% of a property's market price. However, first-time home buyers may be granted loans of up to 90% of the market price in accordance with Article 25(2) of the Consumer Mortgage Act. The purpose of the rules is to maintain financial stability in light of growing imbalances in the housing market and to strengthen the resilience of lenders and borrowers with respect to the possibility of falling property prices.

As before, lenders are encouraged to follow responsible practices in consumer mortgage lending and to use their own risk assessments in decisions concerning lending, as long as the assessment complies with FME rules. Even though the rules stipulate a maximum loan-to-value ratio for residential mortgages they should neither hinder nor discourage lenders from enforcing lower limits in general or in specific cases.

The Financial Stability Council (FSC)[1] has given its opinion on the rules, dated 20th June 2017. In the opinion, FSC endorses FME's recommendations and reaffirms that the current state of the housing market gives reason to consider the resilience of both lenders and borrowers. According to FSC, the rules are well suited to respond to conditions that could threaten financial stability or unduly affect the financial system.

Macroprudential tools and real estate market instability

Instability in the housing market can contribute to excessive financial instability. In order to lessen the possibility of negative shocks or mitigate their effect, caps on loan-to-value ratios, loan-to-income ratios or debt-service-to-income ratios, inter alia, may be applied. Applying such macroprudential tools can have two different objectives: First, to reduce excessive credit growth and thereby mitigate the accumulation of risk in the expansionary phase of the financial cycle, as slower credit growth can indirectly curb real estate prices.[2] Second, to maintain or improve the resilience of households to the possibility of a future price decrease in the real estate market and at the same time decrease lender's expected loan losses.[3]

Supply does not meet demand in the housing market

Real prices in the capital-area housing market have risen considerably during the last few years, most recently increasing by 21.2% between June 2016 and 2017. In recent years, the supply of new residential properties on the market has been significantly below that which can be considered necessary to meet demand.[4] The number of new dwellings constructed in the years following the financial crisis of 2008 was low and supply did not start to improve significantly until 2015. Data on the number of residential properties advertised for sale and average selling times also indicates that supply has been insufficient in meeting demand for housing. The number of residential properties advertised for sale has decreased almost continuously since mid-2010 and is currently lower, and average selling times shorter, than at the previous historical low

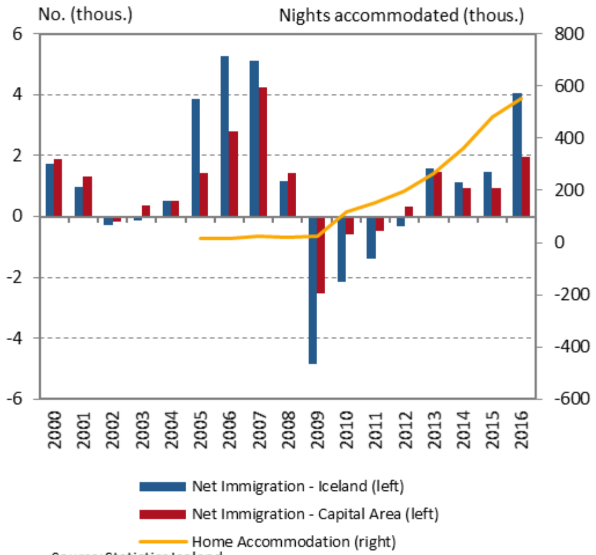
[1] The FSC consists of the Minister of finance and economic affairs (chairman), the governor of the Central bank of Iceland and the Director General of FME.
[2] See for example Cizel et al. (2016), Qi and Yang (2009), Wong et al. (2011), Igan and Kang (2011), Kuttner and Shim (2016), Cerutti et al. (2015), Zhang and Zoli (2016), and Akinci and Olmstead Rumsey (2015).
[3] See further FSC of Germany (2015) and Bank of Lithuania (2011).
[4] See further SI - the Federation of Icelandic Industries (2015), Capacent (2016), and Arion Banki (2017).

during the summer of 2007. While these indicators have risen slightly during the last couple of months, both are still at historically low levels.

The construction sector was slow to recover from the financial crisis of 2008 and did not start growing again to any extent until 2015. Nonetheless, the difference between housing prices and construction costs indicates that it has been profitable to build multi-dwelling housing since around mid-2012. Furthermore, a sizable portion of the construction industry's overall production capacity has been occupied in building non-residential real estate, in particular hotels and other accommodation for tourists. Price increases of smaller residential units in the capital area have outpaced average residential price increases since 2010, indicating greater demand for smaller residences. Data on the rental prices of studio apartments further supports this conclusion.

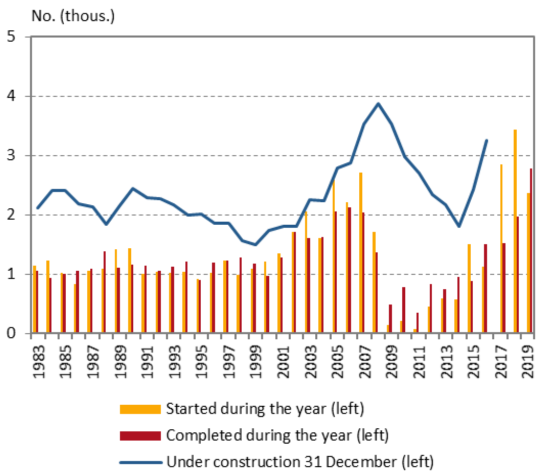
Other underlying factors have also increased the upwards pressure on housing prices. These include a favourable economic climate, growing household income, increased collateral capacity, and improved access to credit; all of which have improved consumers' prospects for purchasing residential real estate. Moreover, net migration has increased in recent years, which has had a significant impact on the demand for housing, much like in the years preceding the 2008 financial crisis.[5] The substantial increase in the number of tourists in recent years may also have influenced the housing market due to increased demand for home accommodation.

Factors affecting demand for real estate



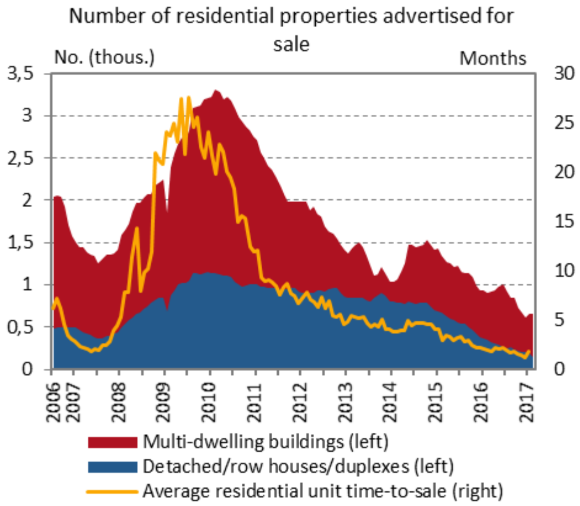
Source: Statistics Iceland

Newly constructed residential real estate in the capital area

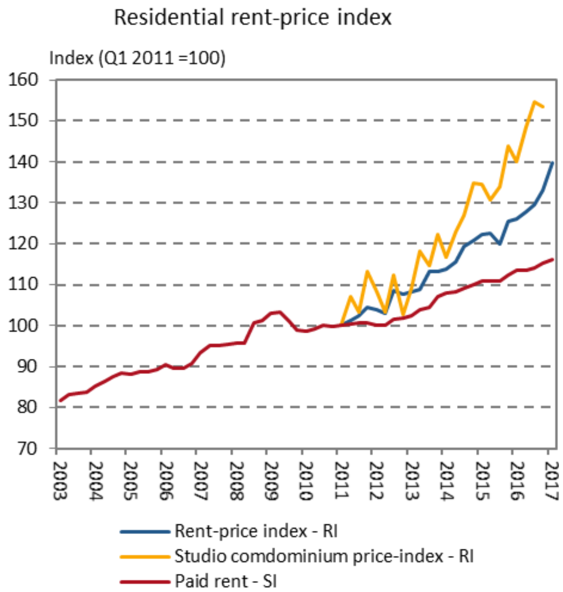


1. Post-2016 numbers are from SI´s assessment based on a survey of construction construction industry members.
Sources: Statistics Iceland and SI - the Federation of Icelandic Industries.

[5] Elíasson (2014) showed that high net migration significantly affected housing prices in the years preceding the 2008 financial crisis.



1. Collated from data from Morgunblaðið's real-estate website and from Registers Iceland.
Source: CBI Economic Indicators (23 March 2017)

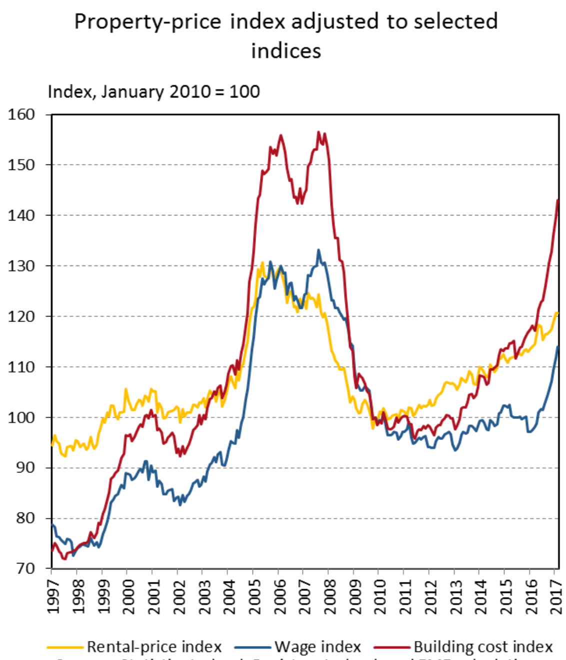


1. Indices adjusted to 2016 real prices based on CPI.
Sources: Registers Iceland, Statistics Iceland, and FME calculations.

Thus, fundamentals indicate continued upwards pressure on property prices. Economic trends remain favourable, forecasts indicate purchasing power will continue to increase this year[6] and net migration is expected to continue to be positive, further increasing demand for housing.[7] Even though investment in new residential real estate is currently increasing, and the number of new constructions growing, the market will continue to be supply constrained in the near future.

The growing imbalance between housing prices and other economic factors

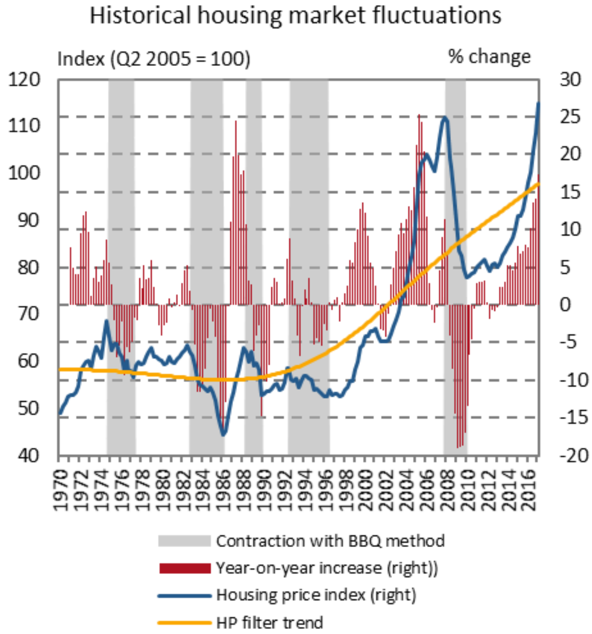
When supply does not meet demand, it can lead to a real estate bubble. When supply is inelastic the likelihood of market expectations being self-fulfilling increases and prices may thus react disproportionately to changes in demand. The longer supply takes to respond to changes in demand, the larger are the potential effects on prices.[8] Increased access to credit by households can also result in excessive credit growth which can lead to additional price increases.[9] Between the 1970s and 1990s, real housing prices fluctuated around a relatively stable level. Since 1996 however, real prices have been trending upwards, the frequency of cycles in the housing market having become lower, while the amplitude of each cycle has become higher. From a historical perspective, the current real price of residential real estate is very high, being



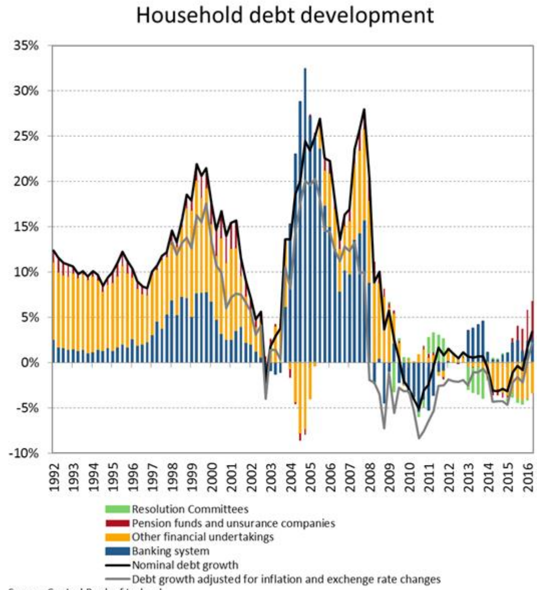
Sources: Statistics Iceland, Registers Iceland, and FME calculations.

[6] Central Bank of Iceland (2017).
[7] Statistics Iceland and Arion Banki (2017).
[8] See for example Case and Shiller (2003) and Glaeser et al. (2008).
[9] See further Bernanke et al. (1999) and Aoki et al. (2004).

3.2% higher than at the height of the last housing boom in 2007. There is thus considerable uncertainty regarding the timing and severity of the next contraction phase and its effects on borrowers and lenders.



1. Fluctuations assessed using BBQ method (Harding and Pagan, 2002), cycles are no shorter than 6 quarters.
2. Housing-prices index adjusted to 2017 prices based on CPI.
Sources: Central Bank of Iceland and FME calculations.



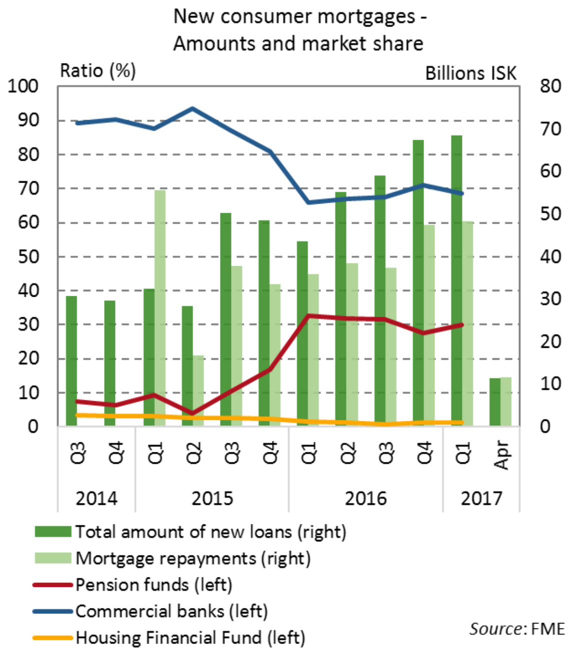
Source: Central Bank of Iceland

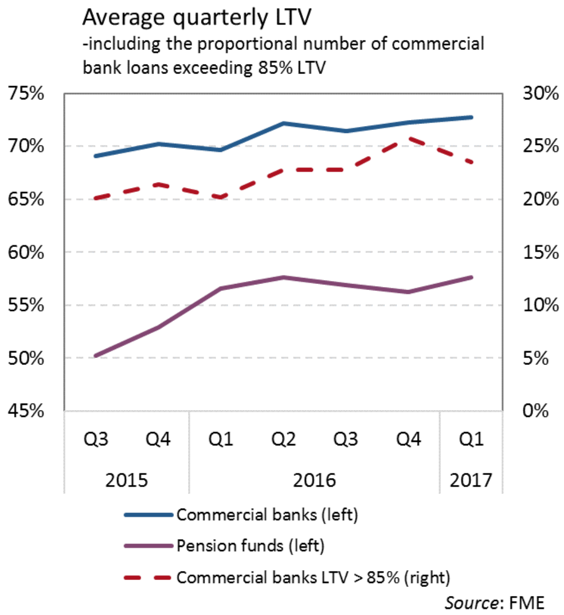
The real year-on-year increase in residential real estate prices in the capital area have exceeded 10% since mid-2016, and 20% since March 2017. Until mid-2016, the increases in housing prices were largely consistent with other indicators such as wages and construction costs. During the past year however, a divergence between housing prices and these underlying factors has formed and continues to increase. For example, the ratio of housing prices to income has grown very rapidly since mid-2016. The current situation in the housing market therefore gives reason to consider the resilience of both lenders and borrowers with respect to potential price decreases.

Lenders have relaxed credit standards

FME regularly collects data on new consumer mortgages from all significant lenders. This data allows the Authority to assess whether risk is accumulating in the mortgage market and the impact rules on maximum loan-to-value ratios, and other macroprudential tools, are likely to have on lenders and borrowers. FME's analysis reflects that lenders have recently been relaxing their credit standards.

Since mid-2015, the average loan-to-value ratio has increased from 69% to almost 73% for commercial banks and from 50% to over 57% for pension funds. The number of loans the commercial banks have granted with a loan-to-value ratio exceeding 85% has, in the same period, increased from 20% to 23.5% of the total number of loans granted each quarter. Furthermore, the average maturity of new loans has lengthened and the proportion of CPI-indexed loans with a maturity of more than 35 years has increased.





These changes, i.e. the rising loan-to-value ratio for mortgages since mid-2015, are likely a result of growing competition in the mortgage market as pension funds have captured a larger market share since mid-2015.

Credit growth in residential real estate is still considered moderate despite the increased collateral capacity and improved financial position of households. Household liabilities on aggregate, adjusted for pricing and currency changes, remained almost unchanged between 2015 and 2016. The total amount of new mortgages has increased somewhat recently. However, a considerable part of this increase, around 70%, has come about as a result of older loans being refinanced. The Rules on maximum loan-to-value ratios for residential mortgages are therefore mainly issued to ensure that lenders do not relax credit standards further in response to increasing competition in the mortgage market, rapidly increasing housing prices, decreasing interest rates and an apparent divergence of housing prices from fundamentals.

FME will continue to monitor the developments in the residential mortgage and housing markets and will review the Rules on maximum loan-to-value ratios for consumer mortgages as needed. FME will also assess, in collaboration with FSC and the Systemic Risk Committee (SRC), whether there is cause to implement other macroprudential tools with the objective of maintaining financial stability.

Assessment of the impact of Rules on maximum loan-to-value ratios

The decision to limit the loan-to-value ratio to a maximum of 85% in general and 90% for first-time homebuyers is based on FME's assessment showing that a limit of 85% in newly granted mortgages is sufficient to strengthen the resilience of borrowers and lenders to a negative shock to the housing market, considering the current situation. FME further concludes that the Rules are sufficient to limit the granting of the riskiest mortgages without unnecessarily constraining the mortgage market as most lenders have already established their own equivalent lending rules. FME's assessment of the rules' impact was presented and discussed by SRC, FSC and FME's Board.

The regulatory process and comments

The draft rules on maximum loan-to-value ratios for consumer mortgages were not subject to consultation before being presented to FME's Board as is normally the case. The reason being that such consultation could have resulted in a temporary relaxation of credit standards and could potentially have affected price formation in the real estate market.

FME's Rules on maximum loan-to-value ratios for consumer mortgages will be reviewed regularly on the basis of developments in the housing and mortgage markets. FME will consider the opinions presented by stakeholders during their review.

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