ANALYSIS

Risks associated with housing company loans are increasing – Regulatory reforms will restrict use of such loans in the future

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Kimmo Koskinen
Adviser


Ville Voutilainen
Senior Data Science Economist

Rising interest rates and rising costs are straining the finances of housing companies in Finland, causing an increase in the direct and indirect financial stability risks associated with housing company loans. Although housing company loan renegotiations are showing a slight upward trend, there is otherwise little evidence so far of debt servicing problems. The way housing company loans are used in the residential property transactions of households and investors has long been a cause of concern for the authorities. Regulatory amendments on the repayment and maximum amount and duration of housing company loans are on their way. These will be important for keeping household indebtedness and credit risks in check.

Elevated interest rates and costs are adding to the direct and indirect risks associated with housing company loans

Households' shares of housing company loans today account for an increased proportion of the overall housing-related debt borne by households in Finland. Large housing company loans in the case of new dwellings, in particular, have increased households' overall indebtedness over the past 10 years and have substantially altered the structure of household debt. A property's share of a housing company loan reduces the buyer's need to take out a large housing loan or investment loan in their own name. The stock of housing company loans in February 2023 was approximately EUR 25.6 billion, accounting for around 15% of household debt and corresponding to 20% of disposable household income.

The way housing company loans are used in the housing transactions of households and investors has long been a cause of concern for the authorities. When purchasing residential property, the buyer must be mindful of the financial charges collected by the housing company to repay the property's share of the housing company loan, as these will form part of the buyer's overall debt servicing costs. If a property's share of a housing company loan is large and if there are long interest-only payment periods, buyers may find it more difficult to estimate the overall costs involved, perhaps causing them to buy a property that is very expensive in relation to their debt servicing capacity and their ability to pay maintenance charges.

Interest rates on housing company loans are currently rising rapidly amid an uncertain economic outlook and falling housing prices. Housing company loans are typically variable rate loans, and the use of interest rate hedging for housing company loans is limited. Indebted households and investors are particularly affected by the strong rise in interest rates. Given the large amount of variable rate loans, the expiry of interest-only periods may lead to a very rapid and substantial rise in debt servicing costs.

According to the Finnish Real Estate Federation, housing companies' maintenance charges are currently subject to significant upward pressure because of the rising cost of living. An increase in housing costs could force households to cut back on other consumption expenditure, which could further weaken the economy. If residential property investors have difficulty finding tenants, this could be reflected in housing company cash flow and could cause debt servicing problems with respect to housing company loans, especially in cases where investors hold a large proportion of a housing company's shares.

Residential property investment that relies heavily on debt financing could amplify cyclical fluctuations in the housing market and the construction industry. Investors might have to sell some of their properties if the returns on buy-to-let housing weaken significantly due to rising costs. This could lead to greater downward pressure on housing prices. In recent years, the demand for new homes has been maintained by residential property investors. However, the weakening level of investor demand has also reduced the number of new build projects for construction companies. Construction companies are at risk of having many unsold dwellings left on their balance sheets.

The difficulties of the buy-to-let housing market add to the risks faced by households, as a substantial proportion of buy-to-let investors are private individuals.[1] A housing company loan is ultimately the shared responsibility of all the shareholders in the housing company, although each property owner is primarily responsible for their share of the housing company loan and for the financial charges. Consequently, the difficulties of investors could undermine the debt servicing capacity of the entire housing company.

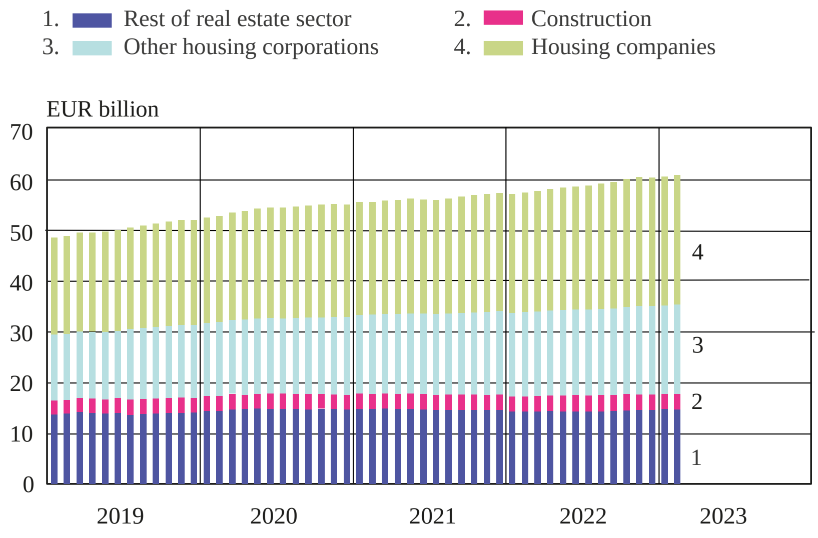
Growth in housing company loans has continued despite rising interest rates

During the past decade, the growth in housing company loans has been significantly above that seen in the traditional housing loan stock. The annual growth in the housing company loan stock has remained strong despite the recent weakening in the Finnish housing market cycle. The stock of housing company loans was up in February 2023 by 8.5% year on year, while at the same time the annual growth in the stock of housing loans has stalled and the amount of new housing loans has diminished considerably (Chart 1).

1. Residential property investors' costs growing rapidly – Bank of Finland Bulletin (in Finnish).

Chart 1.

Housing company loan stock still on the rise in February 2023



Loans issued by banks operating in Finland to industries and/ or sectors related to properties.
Sources: Credit data collection and calculations by the Bank of Finland.

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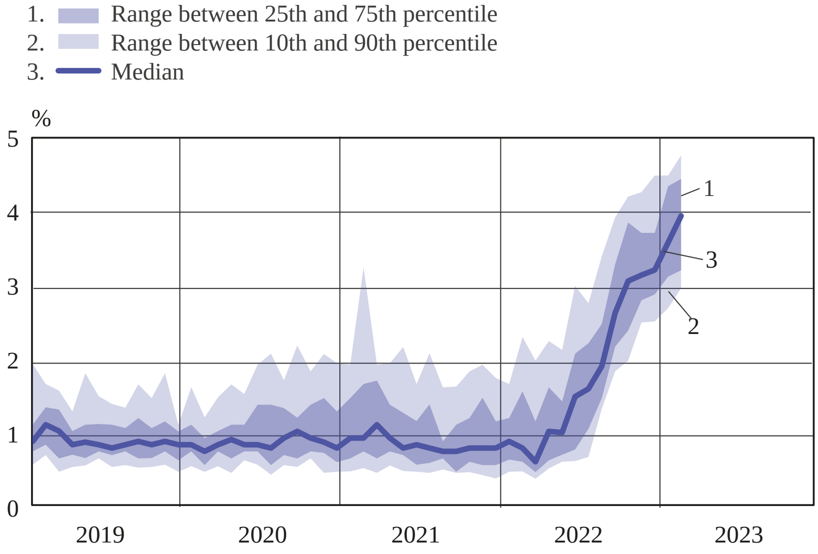
The growth in the housing company loan stock is being maintained by the relatively brisk new build activity and renovations. A large number of new homes are due for completion in 2023 in the Helsinki metropolitan area and in the growth centres. This year, the increase in the number of housing company loans can be expected to slow down due to a substantial decrease in the number of new residential building permits.

The exceptionally sharp and rapid rise in interest rates has also been reflected in the housing company loans that have been granted. The average (weighted median) interest rate of new housing company loans[2] in February 2023 was approximately 4.3%, while as recently as June 2022 it was 1.6% (Chart 2). During the pandemic, the interest rate distribution for new housing company loans widened, especially due to the highest observations (i.e. the difference grew between the highest and lowest interest rates being paid). During the current interest rate shock, the interest rate distribution for housing company loans has changed fairly evenly. This indicates that the rise in interest rates has affected the debt servicing burden of housing companies in a uniform manner.

2. For new loan agreements.

Chart 2.

Substantial increase in housing company loan interest rates due to general rise in interest rates



Interest rate distribution for new housing company loans (weighted percentiles).
Sources: Credit data collection and calculations by the Bank of Finland.

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Housing companies' tighter finances have not yet led to an increase in bank credit risks

So far, the tightening financing conditions have been visible in the credit standards for housing company loans only as a rise in lending rates. Although in the final quarter of 2022 a marginally higher proportion of all housing company loans were renegotiated, the increase was not significant in comparison with previous years (3.7% of the loan stock in December 2022). Reasons for renegotiations include a change in the repayment schedule, reference rate or loan margin. In contrast with lending to households, banks can unilaterally change the agreed loan margin in the case of a housing company loan.

Increasing debt servicing problems could also lead to greater flexibility in debt servicing. Banks offer flexibility in debt servicing to customers with moderate and temporary liquidity problems in order to provide them the chance to improve their financial situation. In the case of housing company loans, the proportion granted flexibility in debt servicing has remained very small (0.2% of the loan stock in the final quarter of 2022).

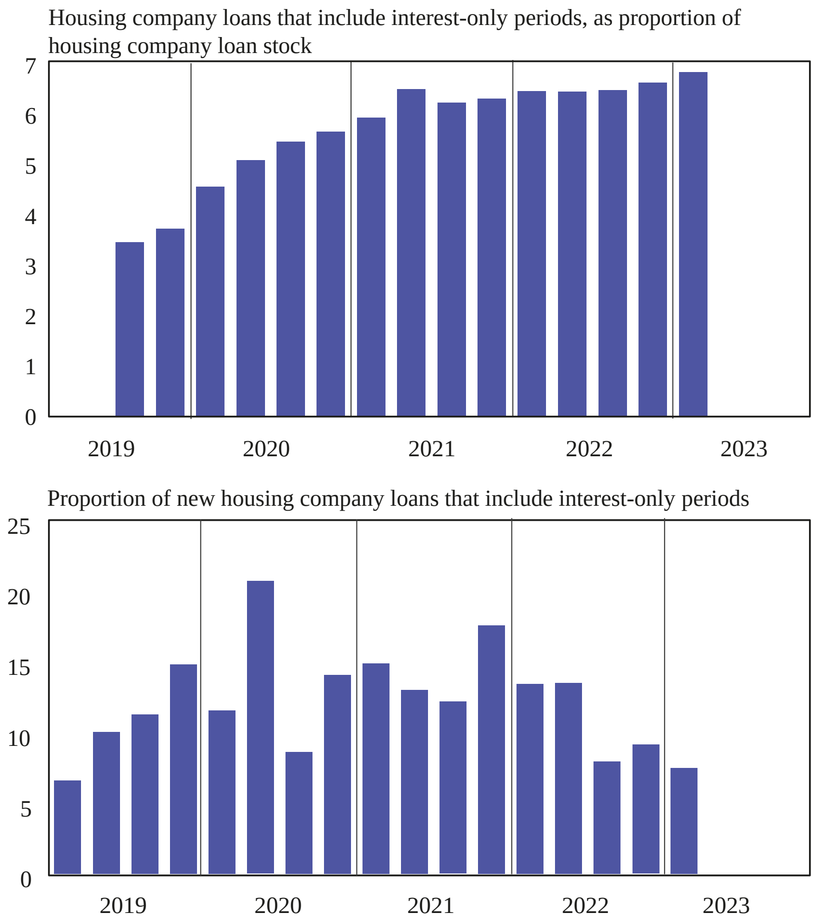
Interest-only payment periods[3] have increasingly been applied to housing company

3. 'Interest-only period' refers here to cases where it is only interest that is required to be paid on the loan at that time.

loans in recent years. In early 2023 (January–February), the proportion of the entire housing company loan stock to which interest-only periods applied was approximately 7%. The corresponding pre-pandemic figure was less than 4%. In new housing company loans, the proportion has been around 12% on average, although there has been considerable variation (Chart 3). The figure was at its highest in the second quarter of 2020, at just over 20% of all new housing company loans. Since then, the share has decreased, and in early 2023 (January–February) it was about 7.5%.

Chart 3.

Interest rate shock has not led to more prevalent interest-only periods in new housing company loans, %



An interest-only period is deemed to apply to a loan if the final date of that period has been entered for the time following the reporting period. The last observation for the first quarter of 2023 is for January–February.
Sources: Credit data collection and calculations by the Bank of Finland.

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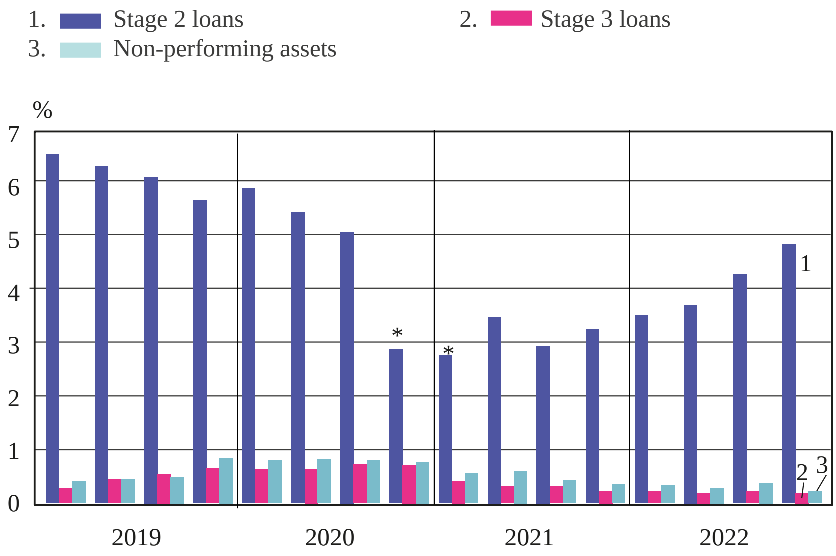
performing housing company loans. The share of non-performing loans has, in fact, diminished since the pandemic. All in all, the amount of non-performing housing company loans is small. However, the amount of loans with an increased credit risk (Stage 2 loans[4]) has increased in recent years (Chart 4).

Any financial difficulties that housing companies and their shareholders might have will not be immediately perceptible in banks' credit risk indicators, as there are several ways in which housing companies can improve their financial health. Housing companies strive to mend their finances primarily by raising the financial and maintenance charges, or by collecting additional charges. They can also take possession of properties for which the charges have not been paid.[5] If the financial situation remains challenging for a long time, the problems may become visible – after some delay – in the form of increased credit risks and credit losses for banks.

Chart 4.

Volume of loans with an increased credit risk is on the rise



The information for each quarter is from the end of the quarter. The observations regarding stage 2 loans in quarters 2020Q4 and 2021Q1 (marked with asterisks) include some abnormalities and should therefore be interpreted with caution.
Sources: Credit data collection and calculations by the Bank of Finland.

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4. The Bank of Finland defines loans in this increased credit risk class as loans in which it deems credit risk to have increased substantially since being issued.
5. According to the Finnish Real Estate Federation, payment arrears among housing company shareholders have increased only moderately for the time being.

New legislation will impose restrictions on loans to households and housing companies

At the beginning of July 2023, legislation[6] will enter into force that will impose restrictions on loans to households and will introduce new regulations, particularly on housing company loans. The aim is to curb the level of household indebtedness from mortgages and housing company loans used in new-build construction, and to improve the transparency of indebtedness risks to homebuyers. The legislation will also limit the extent to which residential property investors other than households can use housing company loans for financing their investments.

Regulatory amendments affecting housing company loans – In brief

- In new-build construction, housing company loans can account for no more than 60% of the unencumbered price of the homes sold.
- In new-build construction, the repayment period for housing company loans can generally be no more than 30 years.
- During the first 5 years after the completion of a building, any interest-only period can be no longer than 1 year.

The lender[7] can, however, diverge from the maximum repayment period in the case of 10% of its loans.

According to information from the Federation of Real Estate Agency in Finland, in a very high proportion (around 63%) of the completed transactions for new-build apartments and terraced houses in early 2023 (January–February), the property's share of a housing company loan exceeded the forthcoming 60% maximum limit (Chart 5). Very large shares of housing company loans also remain fairly common: the property's share of a housing company loan exceeded 70% in around 21% of transactions. Nevertheless, such large shares of housing company loans have been in decline since 2018.

Based on completed transactions, setting the loan-to-value limit at 60% could have an impact on the construction of new builds and on the financing of housing transactions. Replacing housing company loans with homebuyers' own housing loans would make the loan repayment obligation clearer for buyers. If households and investors choose not to replace a reduced housing company loan share with a residential mortgage, this could

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6. See https://www.eduskunta.fi/FI/vaski/KasittelytiedotValtiopaivaasia/Sivut/HE_101+2022.aspx (in Finnish).
7. All the lenders that currently issue housing company loans in Finland are credit institutions, although the regulation also applies to entities other than credit institutions.

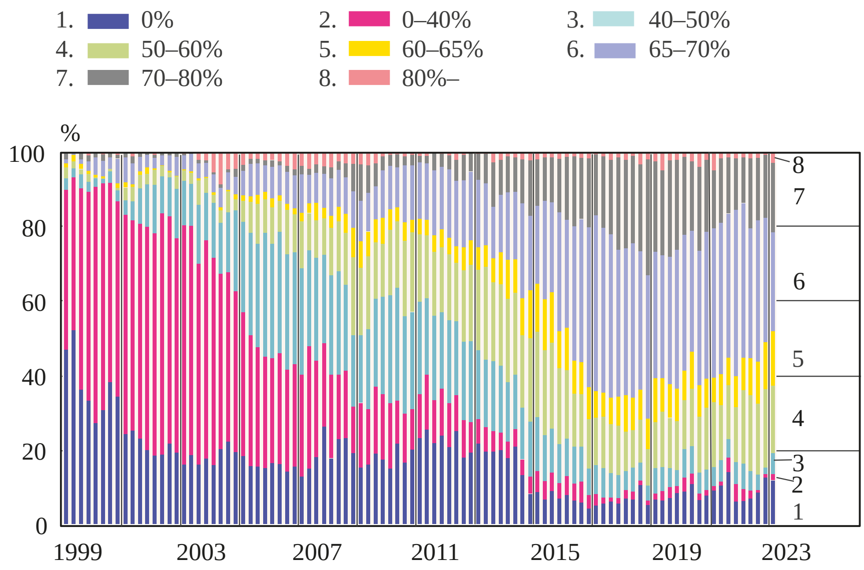
reduce their willingness to buy new residential properties.

The new regulations will make it more important for construction companies to manage their financial risks and balance sheet structure. One potential effect of the restrictions is that a higher number of dwelling reservations would be needed before construction can begin. The loan-to-value limit will mainly affect the construction of owner-occupied homes, as housing company loans are not generally used to finance rental housing projects.[8]

In the government proposal it was considered that restricting the loan-to-value limit could result in a reduction in housing construction. This applies especially to properties whose financing has typically included a major share of a housing company loan. Construction projects that are most dependent on housing company loans typically include those of small construction companies.

Chart 5.

Housing company loan shares exceed 60% in a large proportion of new home sales



The chart presents the proportions of the unencumbered prices of new-build apartments and terraced houses represented by the property’s share of any housing company loan, based on completed transactions by quarter, from 1999Q1 onwards. The last observation for 2023Q1 includes January and February.
Sources: Federation of Real Estate Agency in Finland and calculations by the Bank of Finland.

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8. Imposing a loan-to-value limit on housing company loans would only affect a share of construction finance – Bank of Finland Bulletin.

The new legislation will also restrict the maximum repayment period of housing company loans: in the future, housing company loans will generally include a repayment period of no more than 30 years. In recent years, as little as around 2% of the housing company loans granted have had a duration of over 30 years. Therefore, the new regulation is unlikely in the short term to have a major impact on the granting of housing company loans.

In addition to the maximum repayment period, the new legislation will restrict the duration of interest-only periods. During the first 5 years following the completion of a new build, an interest-only period will be possible only within the first 12 months. According to statistical data collected by the Bank of Finland, interest-only periods used in new housing company loans are predominantly more than one year in duration (about 86% of cases on average, measured in terms of loan volume). In new housing company loans, interest-only periods had an average duration (weighted median) of just over 4 years in 2022.

New regulation is necessary because the increased indebtedness of households from housing company loans has long been a cause of concern for the authorities. The legislation will contribute to curbing excessive risk-taking and indebtedness and will place the regulations for housing company loan practices on a firmer foundation.

Tags

housing markets, regulation, financial stability, housing company loans