HOUSING FINANCE IN ESTONIA: A SHORT NOTE ON RECENT DEVELOPMENTS

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Housing finance has experienced rapid development in Estonia during 2000–2006. In a very open economy with strong macroeconomic policies and the ultimate goals of accession to the European Union and the Economic and Monetary Union, the necessary environment for financial deepening was created already before the year 2000. From the initially very low levels of financial deepening the steady decrease in interest rates and improved credit conditions have boosted household and corporate sector borrowing, which has been strongly supported by foreign funding. As a result, household debt has increased almost five times from the level of 15% in 2000 to the level of 74% of net disposable income in 2006. Improved availability of credit has brought along a robust development in the residential property market where prices doubled during the three years between mid-2003 and mid-2006 and started to level off after that.

The present article aims to provide a short overview of recent housing finance developments in Estonia as well as indicate the main determinants and major implications of these developments.

Section 1 offers an overview of recent developments in the housing finance market. In Section 2 the underlying factors responsible for the direction of last years' developments in the housing finance market are discussed in short. Section 3 deals with the potential implications of these developments for the whole economy as well as the financial sector. Section 4 discusses policy issues that arise in connection with housing finance developments.

DEVELOPMENTS IN HOUSING FINANCE MARKETS

Household debt

Household borrowing in Estonia entered into an active development phase in 1999–2000 in the aftermath of the Russian crisis when large Scandinavian banking groups acquired several of the larger Estonian financial institutions. Initially, banks remained cautious towards the corporate sector and mortgage loans became their main product. During that period the competition for market shares started to intensify. By the end of 2000, the annual growth rate of household credit exceeded 40%, reaching even higher levels during the following years. Starting from 2000, household debt has experienced rapid growth. The ratio of household debt to GDP rose from 8.5% to 41% by the end of 2006 (see Figures 1 and 2). The ratio of household debt to disposable income went up from 15% to 74% by the end of 2006 (see Figure 3 and 4).

Initially, mainly these housing loans, which credit institutions considered to bear a relatively low risk while providing stable long-term cash flows, contributed to the rapid growth of household debt. In the second half of 2005, banks started to offer consumer loans actively as well, which has brought along a rapid growth in loans not directly related to housing. However, their share (including consumer loans) in the total stock of household debt has not increased owing to the low volume of these loans (less than 9% of GDP at the end of 2006).

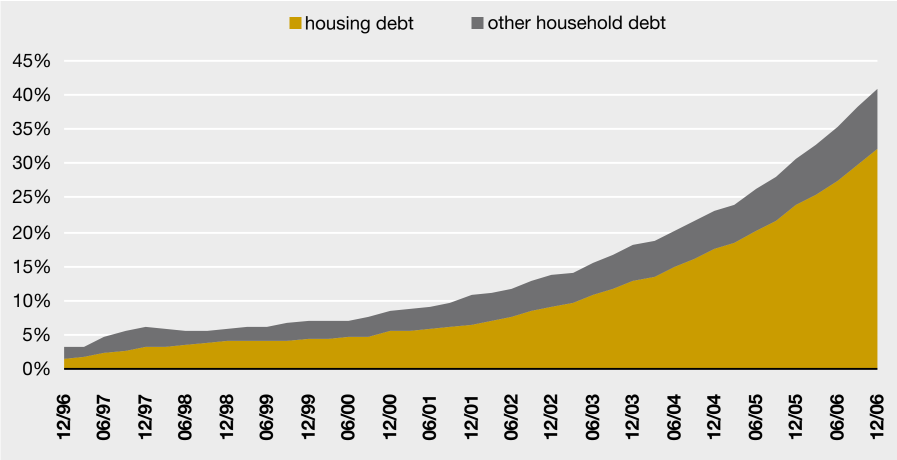

Figure 1. Household debt as a percentage of GDP

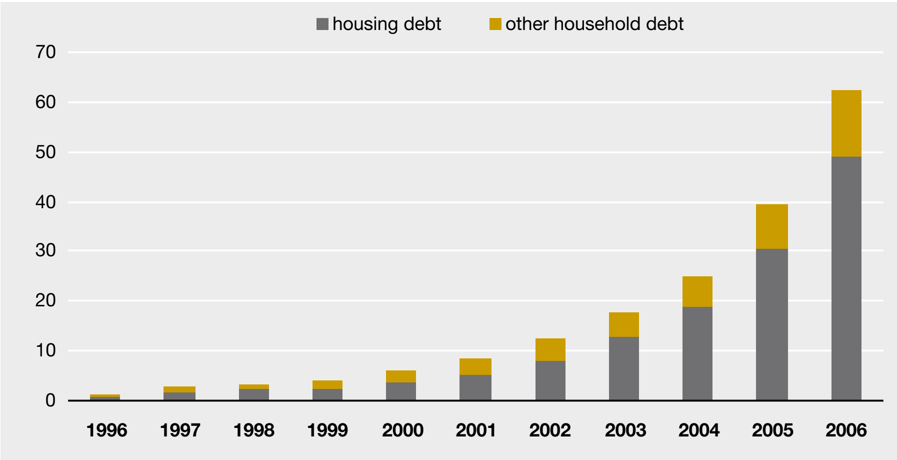

Figure 2. Household debt per capita (EEK thousand)

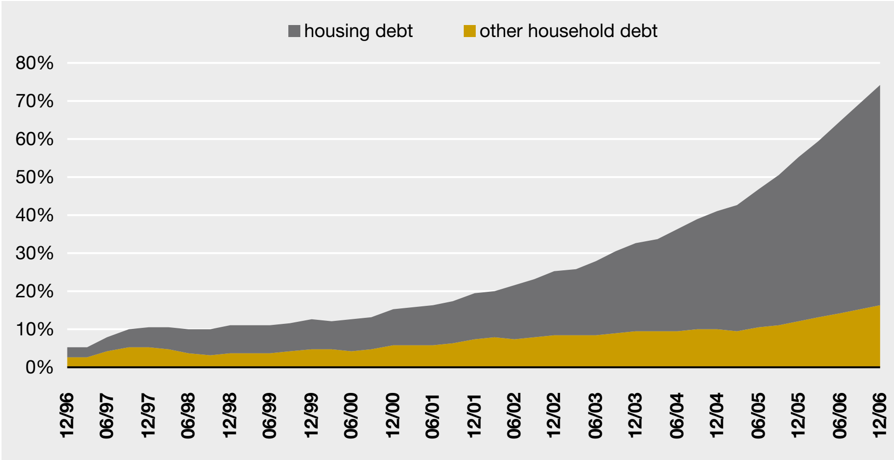

Figure 3. Household debt as a percentage of net disposable income

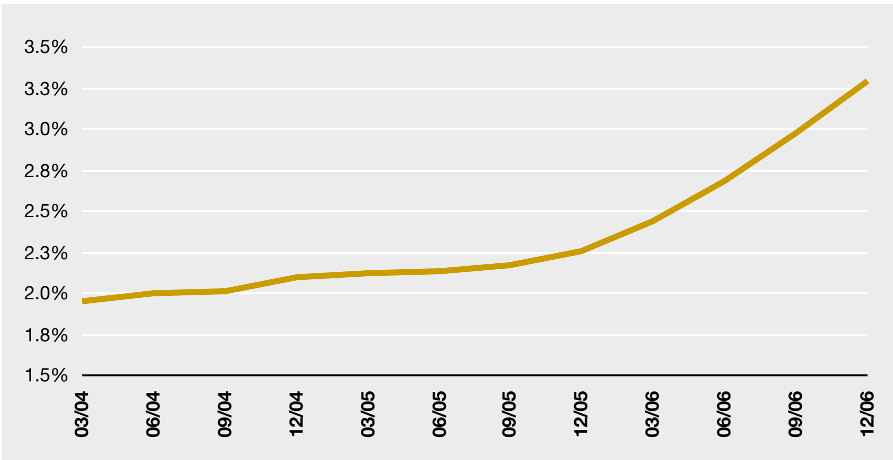

Figure 4. Housing debt service costs as a percentage of net disposable income

Because of Estonia's credible currency board arrangement with an exchange rate fixed to the euro and strong investor confidence in sustained economic convergence, retail interest rates have followed quite closely the euro area interest rates. Declining euro area interest rates and intense competition in the banking market brought the average interest rates of housing loans down from the level of 11.2% at the end of 2000 to 3.1% at the bottom of the interest rate cycle in the middle of 2005. Therefore, debt service costs in ratio to disposable income have grown at a slower rate than debt.

Although household financial assets have expanded at a growth rate of over 20% annually during the previous years, the growth rate of household debt has been even faster and the ratio of household net financial wealth to disposable income has declined during this period (see Figure 5). The share of cash and deposits has decreased and that of other financial assets, such as equities, insurance, investment and pension fund assets, have increased in the structure of household financial assets.

According to household budget surveys carried out by the market research company TNS Emor, the debt is not evenly distributed among households and the bulk of household debt burden is born by households with highest incomes, who presumably also hold the largest share of financial assets.

Residential property prices

Residential property prices have increased in line with the growth of household debt (see Figure 6). The average price of a dwelling in the suburb area of Tallinn, the capital, has reached five times the level of 2000 by 2006. Due to the low level of household savings residential property market developments are largely determined by developments at the housing finance market. For example, residential property prices especially took off in 2004 when banks started to loosen credit terms and conditions by lengthening repayment periods and lowering minimum down payment requirements, which enabled potential customers to take out larger amounts of credit.

Lenders

Estonian financial sector is dominated by commercial banks and the banking sector is a hundred per cent privately owned. Majority of household lending is provided by commercial banks. Leasing provided by bank-owned leasing companies also used to be an important channel for acquiring residential property during the initial development stages of housing finance, but the importance of that has declined in the course of time. In 2006, the share of leasing fell to 1% of total housing lending. The majority of the banking sector is foreign-owned (94% of equity capital) and highly concentrated (C4 stands at 96% and C2 at 78% in terms of total assets[1]). This applies also for the housing finance market – the four largest banks account for 97% and the two largest banks for 75% of the market.

[1] C2 and C4 represent the sum of the share of the assets belonging to two of the four largest banks, respectively, in ratio to the total assets of the banking sector.

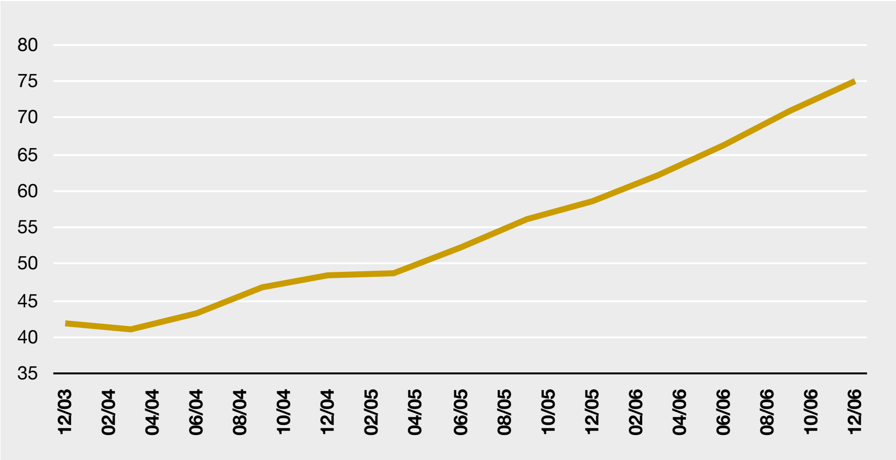

Figure 5. Household debt as a percentage of financial assets

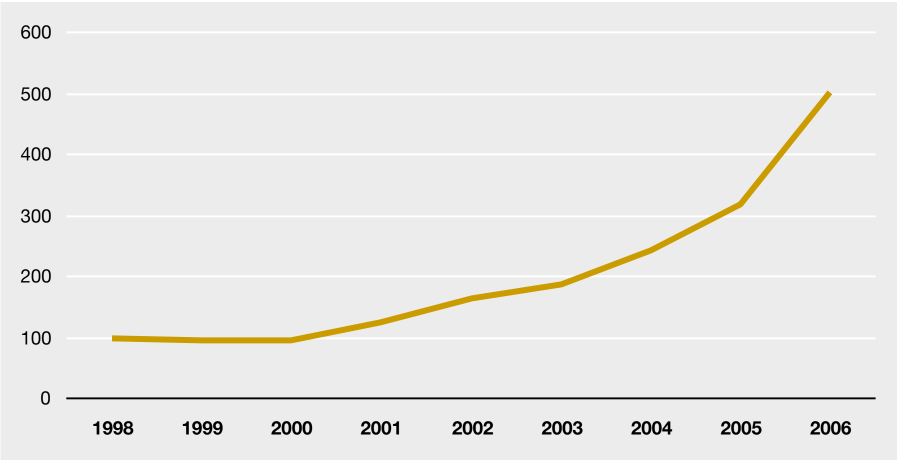

Figure 6. Residential property prices (1998 = 100)

Source: Statistics Estonia, nominal property prices less CPI

Loan types and contract features

The history of the housing finance market in Estonia is relatively short. For the most part, borrowers have experienced only falling interest rates and borrowing with a flexible interest rate has brought along lower debt service costs in the next period. Therefore, the majority of housing loans are variable interest rate loans linked to the EURIBOR with fixation periods of six months up to one year or alternatively to a bank's individual euro prime rate. Credit institutions have started to offer fixed interest rate products more actively after the turn of the interest cycle. However, the interest in these products has remained modest, but it is increasing.

Regarding product innovation, instruments that enable home equity withdrawal[2] and savings mortgages have been introduced to the market in recent years. Loans that enable home equity withdrawal have gained in popularity as residential property prices have grown. However, savings mortgages that are mainly targeted to benefit from tax advantages for long-term savings products have not become especially popular yet.[3]

According to the law, early prepayment of any loan is in most cases allowed. The loan contract involving a variable interest rate may be cancelled at any time by giving three month's notice. There are no legally binding limits for the prepayment fee. According to the law, the additional costs caused to the lender by early prepayment must be borne by the borrower. In case of obligation involving a duty to pay interest, the lender has the right to claim interest for the remaining repayment period until the original due date. In standard terms and conditions of mortgage contracts, however, it is customary to set a fixed amount for prepayment fee.

Regarding other credit terms and conditions, the extension of maximum repayment periods from the previous 20 years up to 30 years has enabled households to take higher amounts of credit without increasing their monthly repayment. The effect of this adjustment may be witnessed from the acceleration of the growth rate of housing debt in the second half of 2005, when the share of new housing loans granted with the repayment period of more than 25 years increased from 38% to over 50% by the end of the year. In addition, there has been a trend towards lower minimum down payments that has also enabled customers to take larger amounts of credit.

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[2] Home equity withdrawal takes place when households increase their borrowing against their housing assets for uses other than acquiring housing property.

[3] Savings mortgage is a mortgage loan that is combined with endowment insurance guaranteeing also life insurance (life insurance that pays the face amount of a policy when the insured party dies or at the end of a contractual period). During the life of the loan, a customer is obliged to repay only the interest of the loan and the insurance premium. The repayment of the principal of the loan will be made upon the expiry of the loan term by the insurance company. Monthly payments will earn interest during the life of the loan, and guaranteed interest and additional interest on the additional profit of the company.

Funding and financial markets

The recent rapid growth of household debt has been significantly supported by funding provided by the parent banking groups of the major credit institutions operating in Estonia, although domestic deposit growth has also been solid. Institutional borrowing including funds from parent banks and borrowing from the international markets constitutes approximately 40% of credit institutions' total liabilities.

FACTORS THAT HAVE CONTRIBUTED TO THE RECENT DEVELOPMENTS

Without presuming to offer an exhaustive analysis of all the different factors that have had an impact on the recent developments in housing finance in Estonia, the present article aims to point out the most important ones combining both demand- and supply-side factors.

(1) Decrease in average interest rates:

Due to the decrease in euro area interest rates setting the base for interest rates in Estonia, lower average interest margins resulting from a decrease in risk premiums and strong competition in the banking sector, the average interest rate on housing loans fell from 11.2% at the end of 2000 to 3.1% in the middle of 2005 (at the bottom of the interest rate cycle).

(2) Improved availability of credit, better terms and conditions:

The availability of credit has been enhanced by virtue of extension of maximum repayment periods from the previous 20 years up to 30 years and the lowering of minimum down payment brought about by intense competition.

(3) Increase in net disposable income:

Due to an increase in gross wages, a decrease in personal income tax rates and a rise in the tax-free minimum income level, the net disposable income of the household sector has more than doubled during the period from 2000 until 2006.

(4) Improved availability of foreign funding for credit institutions:

Rapid growth in housing loans has been significantly supported by foreign funding provided by non-resident parent banks of large banks. Parent banks are interested in increasing their market share in Estonia as the local market offers considerably higher interest margins compared to mature markets.

(5) Expectations related to the EU and euro area membership:

Becoming a member of the EU and perspectives of joining the euro area have contributed to the increase in the credibility of the economy, bringing along a decrease in risk premiums. Optimistic expectations towards future earnings as well as the future rise in property prices have given an extra boost to the growth of housing loans and residential property prices.

INCENTIVES PROVIDED BY PUBLIC AUTHORITIES

Regarding government incentives to the housing finance market, interest payments for a loan or finance lease taken in order to acquire a house or apartment are personal income tax deductible. The maximum amount of all deductions allowed per year was decreased from 100,000 EEK to 50,000 EEK as of 1 January 2005. Against the background of falling debt service costs, the impact of the tax deductibility of interest payments on the demand of housing loans has diminished.

Moreover, a fund named KredEx with the objective, among others, to support bank and leasing financing of home purchase and renovation via providing a guarantee has been operating under the jurisdiction of the Ministry of Economic Affairs and Communications since 2001. Initially, loan guarantees were very successful – guaranteed loans accounted for 29% of the housing loans granted in 2001. Over the next few years the terms and conditions of bank credit improved and the demand for KredEx's guarantees on the mortgage credit market decreased. In 2006, only 2.8% of the housing loans granted were guaranteed by KredEx.

IMPLICATIONS OF RECENT HOUSING FINANCE DEVELOPMENTS

Macroeconomic implications of rising household debt

Rapid credit growth in a convergence economy should be seen as a positive phenomenon as corporate sector and households with low level of savings are able to invest and consume out of their expected future income. In case of converging economies the indebtedness of the economy is initially underdeveloped, well below the level perceived to be justified by the fundamentals. Rapid credit growth is mainly a reflection of a process of financial deepening. However, when the indebtedness of the economy exceeds the fundamentally justified level, credit growth may be considered excessive and potentially risky.[4]

The macroeconomic implications of rapid growth in household indebtedness are centred around concerns about the possible deterioration of the households' ability to service debt under worsening economic conditions. In case a rapid credit growth is fuelled by inflows of foreign savings, rising indebtedness may bring along a sudden shift in expectations and increase in risk premiums.

Regarding the macroeconomic implications of residential property prices, according to a recent study by Eesti Pank[5], the wealth effect manifested by the long-term marginal propensity to consume out of housing wealth is relatively low: 1.1% of the change in real estate value.

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[4] Although many recent studies have offered several approaches to determine the optimal or fundamentally justified level of indebtedness, there is no commonly accepted method yet.

[5] Paabut, A., Kattai, R. (2007) "Does the Increase in Housing Value Influence Private Consumption in Estonia?" Working Papers of Eesti Pank, 5/2007 (currently in Estonian only).

This can partly be explained by the fact that the majority of residential property is owner-occupied and the share of credit-eligible households is relatively small.

Implications and risks for financial institutions

According to the financial accelerator theory, economic agents tend to take a somewhat overoptimistic view of the economic prospects when the economy is improving. That could lead to overly optimistic valuations of collateral and consequently higher amounts borrowed. During the downward phase of the business cycle, the expectations are adjusted and the valuations of the collateral and the demand and supply for loans decrease. The optimism of lenders and borrowers during the upward phase of the business cycle may receive an additional boost from intensified competition between credit institutions (that has been the case in Estonia). The result, in this case, may be a further loosening of the terms and conditions of credit, leading to an increase in risk taking for financial institutions.

The fact that the majority of the housing loans outstanding are variable interest rate loans means that households are all the more vulnerable to increased debt service costs. Stress-tests, however, have indicated that the effects of an increase in interest rates on household debt servicing ability are moderate. This can be explained by the fact that households that have taken a housing loan are in higher income brackets with a high level of net financial assets. However, stress-tests also show that households that have taken a loan in the recent 12 months are the most vulnerable to shocks. That might be seen as a possible reflection of looser loan terms and conditions and higher risk taking by credit institutions.

Still, current indicators of credit quality are at their historical best and credit institutions seem to be adequately capitalised to absorb losses from a potential worsening of credit quality according to the stress-tests. The aggregate capitalisation of the banking sector reached the level of 13.1% at the end of 2006 (in Estonia, the capital adequacy requirement is 10%), whereas the share of loans overdue for more than 60 days is 0.3% of total loans, which are 1.5 times covered by credit loss provisions.

POLICY ISSUES

Eesti Pank has been closely monitoring credit developments to prevent the inevitable risks related to real and nominal convergence in the financial sector and the mortgage market. On two occasions, in 2003 and 2004, the central bank together with the Financial Supervision Authority reminded credit institutions also formally of the potential risks related to rapid credit growth. In 2005, the risk weighting applied to housing loans was increased from 50% to 100% as of 2006. As an additional measure, in July 2006 the reserve requirement was increased from 13% to 15% as of 1 September 2006. Possible risks to macroeconomic and financial stability are further mitigated by the broadly appropriate fiscal stance. The Estonian Government has achieved sustained and significant budget surpluses for six consecutive years.

Since the second half of 2006, the housing finance market has been showing some signs of stabilisation. Against the background of high price level reached, the demand for residential property has decreased and the growth of residential property prices has started to slow down, and so has the growth of housing loans. Furthermore, credit institutions have developed a less optimistic approach towards the future potential of the housing finance market, which means that the credit terms and conditions for residential property development firms are tighter now. However, the reflection of that may probably be witnessed more clearly from the statistics starting from the second half of 2007.