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Imposing a loan-to-value limit on housing company loans would only affect a share of construction finance

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Housing company loans are contributing to household indebtedness and are changing the composition of household debt. Housing company loans can also incentivise residential property investors to become highly leveraged. Imposing a loan-to-value limit of 60% on housing company loans would mitigate the issues associated with large housing company loans and make it easier to assess their risks. The impact of a loan-to-value limit would largely fall on owner-occupied housing output. Housing company loans are generally not used to finance the construction of rental housing. Imposing a loan-to-value limit on housing company loans might increase the number of pre-sales required by small construction companies or raise their borrowing costs.

Large housing company loans are changing the composition of household debt

In October 2019 a working group[1] appointed by the Ministry of Finance proposed new measures to curb the growth of household debt in Finland. The proposed measures included restrictions on the use of housing company loans to finance new build construction. The working group proposed that housing company loans for new builds should not exceed 60% of the unencumbered price of the flats to be sold; the maximum maturity on housing company loans should, as a rule, be limited to 25 years; and housing company loans should not be eligible for amortisation-free periods during the first five years from the commissioning of the building and the transfer of the dwellings to their buyers.

A housing company loan share is the share of a housing company's long-term liabilities allocated to a particular shareholder of the housing company. The concerns surrounding large housing company loan shares highlighted in the ministerial working group's report relate especially to new build housing. A flat can have a low sales price if a large proportion of its unencumbered price is made up by a housing company loan. The housing company loan reduces the need of the buyer to take out a large housing loan or investment loan. Yet large housing company loans are raising the overall indebtedness of households in the economy and are changing the composition of household debt.

Imposing a loan-to-value limit on housing company loans would not change the unencumbered price of a flat. It would restrict the amount of housing company debt allocated to the housing shares being sold, resulting only in a higher sales price. This would likely raise the demand for housing loans. Shifting the balance away from housing company loans in favour personal housing loans would clarify the responsibility associated with the loan and make the debt-servicing costs more transparent to the buyer.

When purchasing a flat, financial fees collected by the housing company to pay down the flat's share of the housing company loan should be recognised as part of the flat's overall loan-servicing costs. Large housing company loan shares and long amortisation-free periods impair the ability of buyers to assess the total costs and debt-servicing burden associated with a flat.[2] Although the owner of each flat is principally responsible for meeting his or her share of the financial fees collected by the housing company, liability for the housing company loan ultimately falls on all the housing company's shareholders.[3]

The large housing company loan shares of new build housing can incentivise residential property investors to take on leverage. This, in turn, can amplify cycles in the housing market and construction industry. If investors face difficulties in renting out their flats, this might lead to repayment delinquencies for the housing company, especially in cases where investors hold a large proportion of the housing company's shares. Declining demand in the rental market could force investors to sell off their dwellings, resulting in broader ramifications for house prices.

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1. See https://vm.fi/en/-/household-indebtedness-must-be-curbed-with-new-measures. The Bank of Finland issued an opinion on the working group's report concluding that the proposals were well-justified.
2. According to the Bank of Finland's Analytical Credit Database, the average length of an amortisation-free period agreed for a housing company loan (where applicable) during the past year was for about 2 years, with the longest amortisation-free periods reaching as much as 5 years.
3. Housing companies can also fall into bankruptcy, albeit such occurrences are rare.

The risks for households are related to weakening levels of income and rising debt burdens. When economic conditions falter, households often first cut back on non-housing expenditure, which only weakens the economic cycle further. A rise in housing company payment delinquencies could make it harder for housing companies to borrow the funds needed for maintaining an ageing building stock.

Imposing a loan-to-value limit on housing company loans would largely only affect the construction of owner-occupied housing

According to the Confederation of Finnish Construction Industries (RT), a significant share of Finland's housing output during the past decade has consisted of owner-occupied dwellings.[4] The output of non-subsidised rental housing has, however, grown significantly since 2017. This has coincided with a clear decline in the construction of owner-occupied flats. According to RT's November 2020 housing output survey, non-subsidised owner-occupied and rental housing construction has concentrated especially around the Helsinki metropolitan area.

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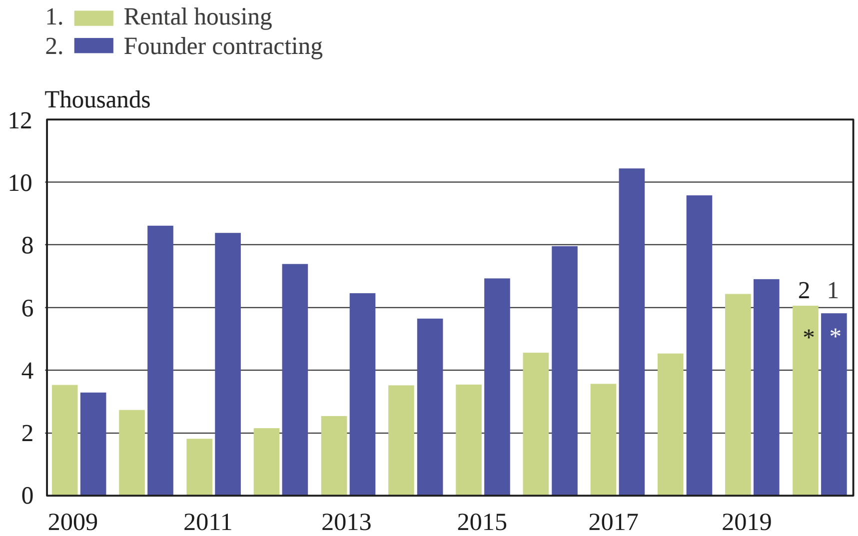
4. Founder contracting begins with a contractor founding a limited liability housing company. After this, the founder contractor constructs the development independently or with the help of a construction company. The founding shareholder must see to it that an appropriate guarantee is issued before the housing shares are offered for sale in order to protect the housing company and share buyers against his insolvency. (Housing Transactions Act, Chapter 2 Section 19). The founding contractor may then open a credit line for the construction project that is undersigned by the housing company (RS-financing). Drawdowns from the RS-facility are recorded on the liability side of the housing company's balance sheet, i.e. as a housing company loan. When the volume of new build construction reached a historical high in 2017, as many as 75% of housing starts were founder contracting developments based on the RS-system. The RS-system protects buyers from the founder contractor falling into bankruptcy during the construction phase as well as from building mistakes and ensures that the development is constructed to specification.

Chart 1.

Construction of rental housing has picked up in growth centres



*Estimate, November 2020.
Source: Confederation of Finnish Construction Industries RT.

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A non-subsidised rental housing development is a construction project where the construction company sells the entire property during the construction phase to an investor who will generally rent out all of the dwellings included in the purchase.[5] The construction of rental housing is usually commissioned by large domestic and foreign property investors as well as institutional investors. Rental housing developments are generally not associated with housing company loans.[6] As a result, imposing a loan-to-value limit on housing company loans would not affect the construction of rental housing in the same way as owner-occupied housing.

A significant proportion of new build sales exceed the proposed loan-to-value limit

According to data by the Central Federation of Finnish Real Estate Agencies (KVKL), 92% of recorded sales of new non-subsidised owner-occupied flats were encumbered with housing company loans in 2020. For old housing stock, 46% of sales were encumbered with housing company loans. There has been a significant rise in how much housing company loans make up the unencumbered prices of new build flats. In recent

5. The demand for residential properties by professional investors has increased in Finland in recent years, and a number of foreign professional investors now operate in the Finnish market alongside large domestic entities.
6. Housing company loans typically only occur here if a housing development has started as a founder contracting development but has for one reason or another later been sold to an institutional investor.

years housing company loans have generally accounted for between 60 and 75% of the unencumbered price of new flats.

Based on data[7] by KVKL, imposing a maximum loan-to-value ratio of 60% on housing company loans might impact on the sales of new builds. Limiting the loan-to-value ratio to 60% would curb the growth of housing company loan shares in new builds.

Shares of new, non-subsidised owner-occupancy housing have also been marketed towards residential property investors in recent years. Here a loan-to-value limit on housing company loans would help mitigate the high use of leverage in residential property investing. When a large proportion of a flat’s unencumbered price is financed by a housing company loan, investors are able to buy housing shares with relatively little equity. Private investors in particular have benefitted from the opportunity to invest in residential housing with small shares of equity. A housing company loan can serve as cheaper source of finance for a residential property investor than a personal investment loan. In addition, investors can take advantage of their ability to deduct interest expenditure and amortisations from their capital gains income. Although there are no comprehensive statistical data on the exact number of private investors[8], various assessments suggest that households have played a significant role in raising housing company loans. According to Statistics Finland's transfer tax data, households might hold over 80% of housing company loans issued for new dwellings.[9] Based on the annual survey conducted by the Finnish Landlord Association, it can be estimated that about one-third of Finnish private investors hold housing company debt. However, only 12% of respondents reported holding housing company debt in excess of EUR 100,000.

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7. KVKL’s data only cover a share of all new housing output. Does not include all brokers. In addition, rental housing is obviously excluded from these statistics.
8. There are, however, new data available on buy-to-let mortgages, for example. For more information, see Bank of Finland Bulletin 1/2021 ‘Separating buy-to-let mortgages from personal housing loans paints a clearer picture of household debt’.
9. Some of the housing company debt held by households has been acquired for the purposes of property investment. Private individuals are estimated to own over 300,000 residential investment properties, which corresponds to about 36% of the rental housing stock. Source: KTI.

Chart 2.

Distribution of housing company loans shares of new and old housing companies in 2020

Sources: KVKL and Bank of Finland.

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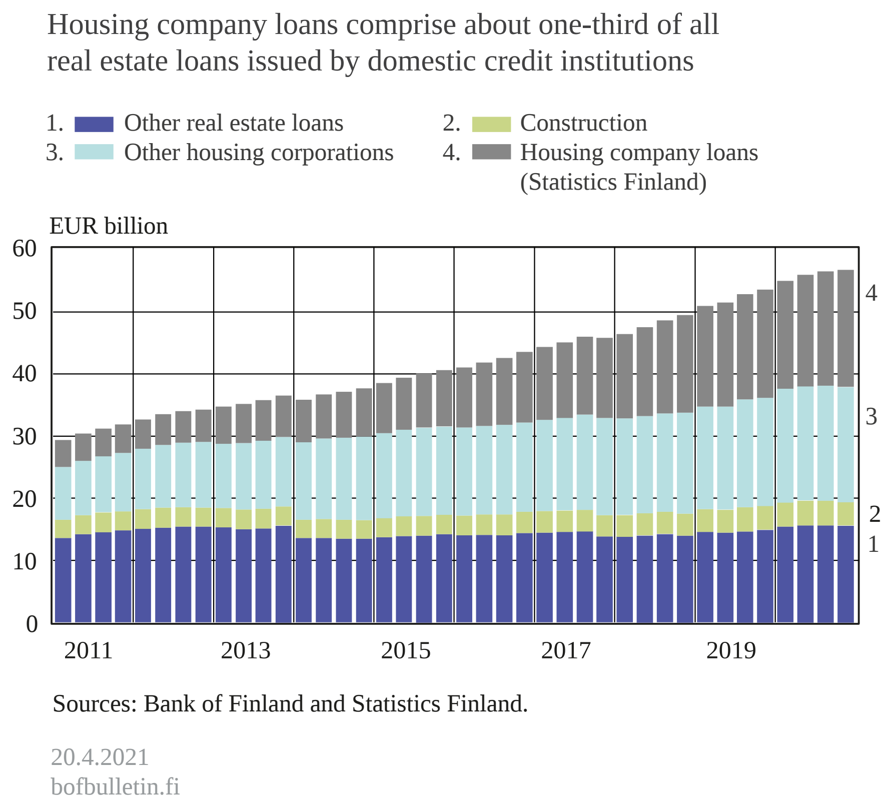
In the national accounts housing company loans are classified as part of the housing corporations sector. In addition to housing companies, the sector includes real estate companies specialised in rental housing and various public housing[10]. The consolidated loan stock of housing corporations stood at about EUR 42.3 billion in September 2020. Credit institutions operating in Finland issue the majority of loans to housing corporations. In addition to banks, housing corporations receive funding from other lenders, including the public sector. The volume of outstanding loans issued by Finnish credit institutions to housing corporations stood at about EUR 37 billion at the end of September 2020 (Chart 3, green bars). Of this, about EUR 22 billion consisted of loans issued to housing companies (Chart 3)[11]. A significant share of the stock of bank loans to housing corporations consists of construction finance for new build housing. Imposing a loan-to-value limit on housing company loans would mostly impact on construction loans for new builds.

10. These specialised real estate companies and public sector entities include large limited liability companies that construct and manage non-subsidised rental properties, real estate investment firms which operate in the rental market and are governed by domestic pension and insurance companies, various non-profit organisations recognised by the Housing Finance and Development Centre of Finland (ARA), and real estate companies controlled by municipalities.
11. Statistics Finland has estimated the stock of housing company loans held by households at EUR 18.4 billion.

Chart 3.



The impact of a loan-to-value limit for housing companies on construction finance

Large housing company loans have in recent years become an established source of finance for the construction of non-subsidised owner-occupied housing. Housing company loans reduce the need for construction companies to seek alternative sources of funding during the construction stage. From the perspective of a builder, a large housing company loan decreases the financial risk associated with a development, as the construction company is only liable for the loan for a limited period of time. The liability of the loan is passed on to the housing company and its shareholders as soon the dwellings have been sold and handed over to the buyers. The RS-system allows for dwellings to be sold already during the construction stage, which also reduces the financial risk for the construction company[12]. Housing company loans and the RS-system are particularly important for smaller construction companies when securing funding for a development, and indeed development work can only be started once a pre-determined number of dwellings have been reserved, usually about 40–50% of the dwellings for sale. With the help of housing company loans even small construction companies can begin work on several developments at once.

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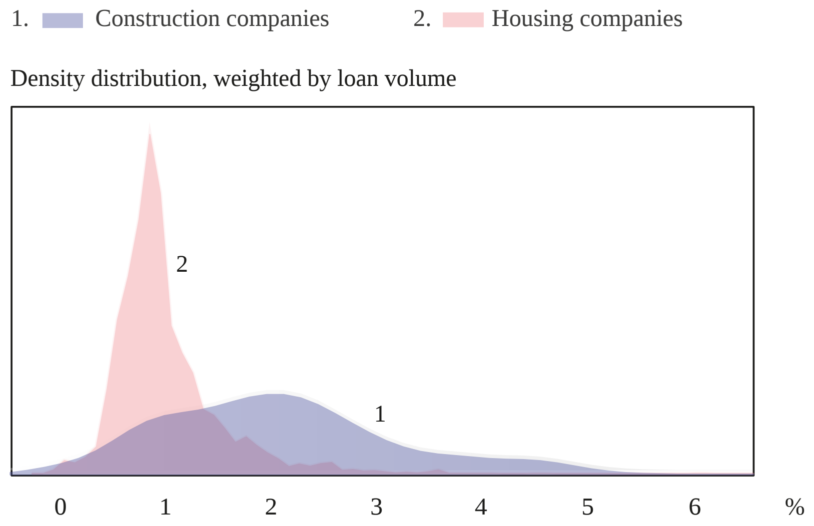
12. See https://www.finanssivalvonta.fi/en/publications-and-press-releases/Press-release/2018/risks-increasing-in-construction-stage-financing-and-housing-corporation-loans2/.

The average interest rate on bank loans issued to construction companies for the build stage is almost 1 percentage point higher than the average rate on the overall loan stock of housing corporations. For smaller companies the RS-loans issued by banks are especially important, as the interest rate paid by small construction companies on bank loans is often significantly higher than that paid by construction companies on average (Chart 4). Smaller construction companies typically have a higher credit risk than large companies, as they have less collateral and their liquidity may be more sensitive to economic downturns than large companies.

Chart 4.

Small construction companies pay substantially higher interest rates on their bank loans than housing company loans



Source: Bank of Finland.

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Large construction companies often have several sources of funding, including, for example, the RS-facility issued for the construction stage, other market-based funding, and deposits collected from buyers. For small construction companies, alternative sources of funding are often scarce. Imposing a loan-to-value limit on housing company loans may affect the borrowing costs of small construction companies if they require other sources of funding than the RS-facility. Another effect of the restriction could be that a higher number of dwellings must be reserved before construction can begin.

Tags

construction, COVID-19, indebtedness, housing company loans, debt accumulation