

Box 3

CHANGES IN BANK LENDING RATES AND NEW HOUSING LOANS IN THE EURO AREA

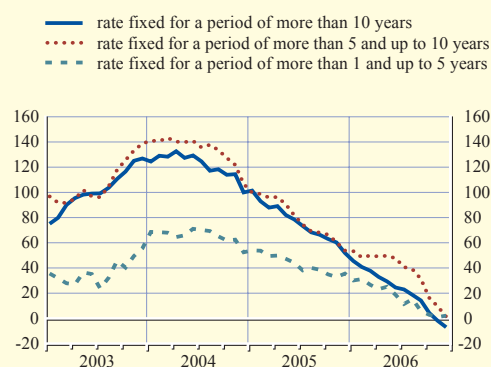
The transmission of monetary policy includes both the pass-through of changes in central bank interest rates to bank lending rates and the impact of changes in bank lending rates on the volumes of lending across the maturity spectrum. Against the background of the increases in the key ECB interest rates since end-2005, this box assesses the extent to which changes in the bank lending rates on loans for house purchase with different periods of rate fixation are reflected in the relative shares of these loans in total new housing loans in the euro area. It uses the information in the euro area MFI interest rate statistics on the bank lending rates on new loans as well as the respective volumes (in terms of gross flows), which is available by purpose of the loans and by period of initial rate fixation.¹

Nominal lending rates on new loans for house purchase have been on an upward trend in the euro area since the end of 2005, in line with the increases in the key ECB interest rates and market rates, albeit still remaining at low levels by historical standards. The increase in the rate on loans with an initial rate fixation period of up to one year, in particular, has been more pronounced than that in the rates on loans with longer initial rate fixation periods. This is in line with the flattening of the market interest rate yield curve that has been observed during 2006. As a result, the rates on new housing loans have all converged to practically the same level, regardless of the length of the initial rate fixation period, i.e. the spreads between the rates on the different types of loans have almost disappeared (see Chart A).

¹ For a description of this dataset, see Box 2 entitled “New ECB statistics on MFI interest rates” in the December 2003 issue of the Monthly Bulletin.

Chart A Spreads between rates on housing loans

(basis points)

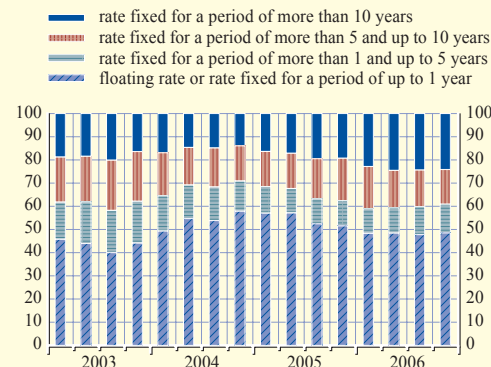


Source: ECB.

Note: The chart shows spreads between rates on housing loans with a longer initial rate fixation period and rates on loans with floating rates or rates fixed for a period of up to one year.

Chart B Breakdown of new loans for house purchase by length of initial rate fixation period

(percentage points)



Source: ECB.

Over the period since 2003, for which euro area MFI interest rate statistics are available, housing loans with a floating rate or a period of initial rate fixation of up to one year (floating rate loans) have formed the largest share of the overall volume of the new business in loans for house purchase. However, their share has fluctuated over this period (see Chart B). It rose from around 40% in the third quarter of 2003 to a peak of approximately 60% in the fourth quarter of 2004 and then gradually declined to its current level of approximately 50%. The increase in the share of floating rate housing loans during the period up to the fourth quarter of 2004 seems to have followed the rise in the spreads between the bank lending rates on this type of housing loans and those on loans with longer periods of initial rate fixation during this period. Similarly, the decline in the share of floating rate loans from the first quarter of 2005 onwards appears to have followed the steady narrowing and eventual elimination of these spreads.

The decrease in the share of floating rate loans from the first quarter of 2005 onwards coincided with a rising share of loans with initial rate fixation periods of more than ten years, to approximately 25% in the fourth quarter of 2006, while the shares of the other two categories (initial rate fixation periods of more than one and up to five years and of more than five and up to ten years) have remained broadly unchanged. Again, this development appears to be linked to the evolution of the respective spreads, as the fall in the spread of loans with initial rate fixation periods of more than ten years vis-à-vis floating rate loans has been more pronounced, particularly during 2006.

The apparent relationship between the evolution of the share of floating rate loans and the developments in the term spread can be interpreted in different ways. It could, for instance, suggest that households choose between a floating rate loan and one with a longer period of initial rate fixation, depending on the initial cost of the different types of mortgage loans. A decision-making process that concentrates on short-term considerations may obviously entail the possibility that households expose themselves to longer-term risks if interest rates increase across the maturity spectrum. Alternatively, the observed relationship could reflect the possibility that households' expectations regarding future interest rates do not always coincide with those of the financial markets. The two explanations could of course be complementary.

However, it should be noted that this analysis only focuses on changes in bank lending rates and does not encompass other factors that may affect household decisions, particularly if they engage in active risk management, taking into consideration not only interest rate risk but also income risk.

In view of the rapid pace of financial innovation in recent years, it cannot be excluded that the evolution of the share of floating rate loans in total new mortgage loans also reflects supply-side developments.² These include changes in the underlying structure of countries' financial markets with respect to e.g. the liquidity and depth of covered bond and mortgage-backed securities markets and the availability and pricing of hedging instruments. For example, as the markets for covered bonds and mortgage-backed securities become more liquid, banks tend to finance themselves more by tapping into these long-term financial markets and less through attracting short-term deposits. As a result, they are able to offer loans to households for mortgage financing with longer periods of rate fixation.

To sum up, it appears that the changes in the share of floating rate loans in total mortgage loans since 2003 seem to follow the evolution of the interest rate spreads between loans with varying interest rate fixation periods. However, it should be noted that this pattern masks significant differences across individual countries. These differences reflect inter alia some heterogeneity in both household preferences and supply-side factors such as the general availability and pricing of certain products.

² See IMF (2004), "Adjustable- or Fixed-Rate Mortgages: What Influences a Country's Choices?", World Economic Outlook, September, Box 2.2.