



**Genworth**  
Financial

*Built on GE Heritage*



Dear Reader,

Welcome to the first issue of our Nordic Quarterly Bulletin – a publication which focuses its attention on mortgage markets across the Nordic Region and examines current and future issues facing Lenders and the Finance Industry in general.

In this issue we take a look at the Basel II Accord and how it impacts Lenders in terms of data, credit risk management and capital requirements. We also share some interesting findings following a recent study on Swedish Consumers.

Regular features will include a section on key economic and housing market indicators – information that we hope will be of benefit to you in your daily work.

**Claes Billing**  
Managing Director, Nordic  
Mortgage Insurance - Europe

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## FORTHCOMING EVENTS

**March 2005**  
**Genworth Financial Mortgage Market & Credit Risk Seminar**

Who Should Attend? CEOs , CFOs and Credit Risk Managers from Lending Institutions

To pre-register your interest in this event,  
please e:mail [camilla.zakrisson@genworth.com](mailto:camilla.zakrisson@genworth.com)





# ABOUT GENWORTH

*You've known us as  
GE Mortgage Insurance ....  
Now we are  
Genworth Financial*

## ABOUT GENWORTH FINANCIAL IN EUROPE

Genworth Financial is a leading insurance holding company, serving three major customer needs: protection, retirement income and investment and mortgage insurance. We have more than 15 million customers, with operations in more than 20 countries, including Australia, Canada, Denmark, Finland, France, Italy, Ireland, Germany, The Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, the UK and the US.

**In Europe,** Genworth is a major provider of mortgage insurance, which helps to expand homeownership through low down payment lending and payment protection insurance, which helps consumers meet financial commitments if they are unable to work.

Genworth's products are distributed through financial institutions and their captives, who offer the products, either in connection with underlying loans or other credit products they sell to their customers, or as an independent product.

### About Mortgage Insurance

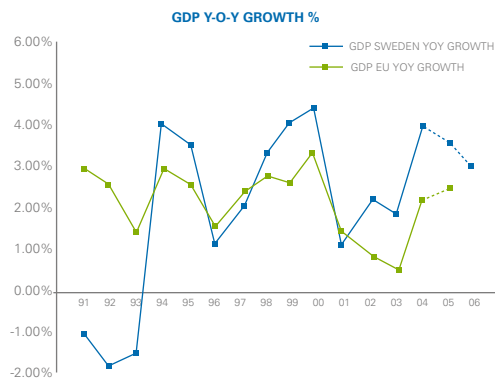
Mortgage Insurance (MI) is a type of insurance designed to protect lenders in the event that a mortgage borrower defaults on a loan and the proceeds of the sale of the property are insufficient to pay the outstanding debt.

Due to its credit protection features, MI extends home ownership opportunities to consumers by enabling house purchase with lower deposits. Since lenders are protected from credit losses they are more likely to lend to consumers with lower deposits.

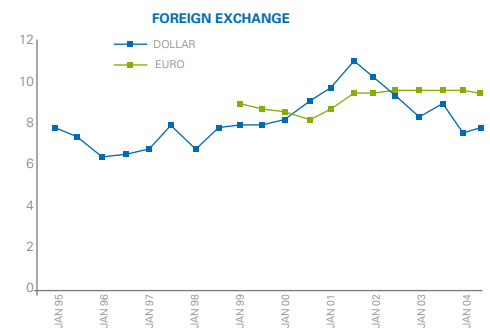
In addition, MI from a highly rated mortgage insurance company, can facilitate the sale of High Loan To Value portfolios on the secondary market.



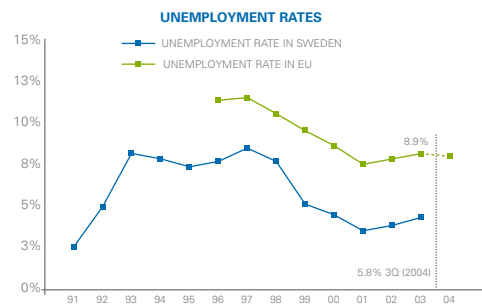
# MACRO ECONOMIC INDICATORS



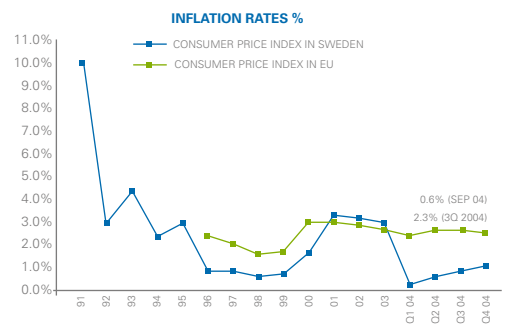
Sources: Consensus Forecast



Sources: Consensus Forecast



Sources: SCB 2004



Sources: Consensus Forecast

## MACRO ECONOMIC FIGURES

### *Rapid Growth in Second and Third Quarters*

The Swedish economy showed rapid growth in the second and third quarter, primarily from surging exports. The forecast for GDP growth this year has now been revised upward to 3,8 percent. After several years of decline, investment is also on the rise. This year, increasing foreign demand for Swedish exports is driving growth.

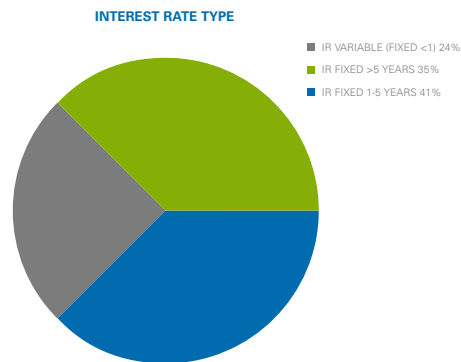
Inflation rates are still low, 0,8 percent in October, despite the rapid growth in GDP. However, they have a slightly upward trend curve that is expected to be maintained during the fourth quarter and at least throughout 2005.

The unemployment level has during the first 3 quarters increased from 4,9 to 5,8 percent, but has started to show signs of stabilisation. The forecast is that the unemployment rate will gradually decrease during 2005 and 2006.

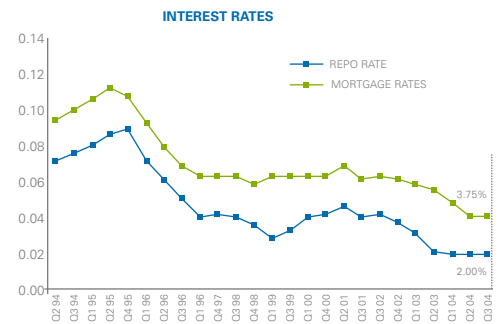
The Riksbank have not changed the Repo rate since the beginning of April. The early forecast was that an increase would take place during this autumn. However, as a result of several negative reports regarding the economy it has been postponed and now the forecast is that we will see an increase of between 0,25-0,5 percent during the second quarter 2005.

The Swedish Krona has grown stronger in comparison with the US Dollar during the last couple of month and is now on a similar level as 1998. The Euro exchange rate has not been so volatile as the Dollar rate but we can see that the strength in the Krona is now showing also in this rate.

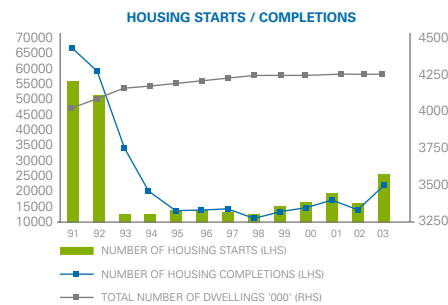
# HOUSING AND MORTGAGE MARKET



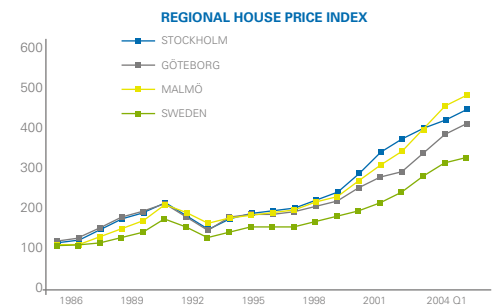
Sources: Consensus Forecast



Sources: Consensus Forecast



Sources: SCB 2004



Sources: Consensus Forecast

## HOUSING AND MORTGAGE MARKET

Construction of new buildings has started to pick up from a low level on the Swedish market. The demand for apartments/ houses in the big cities is still higher than supply, which will keep the prices high.

*Malmö Region is the most Prosperous Market*

The prices on the overall housing market in Sweden are still climbing after nearly 10 consecutive years. The Malmö region has been the most prosperous market during the last couple of years and is now the overall leading market from a price index point of view.

The market trend regarding Mortgage loans is that the consumer is going for fixed interest rates instead of variable rates. During the third quarter the overall chosen market share of flexible loans went down from 38% to 24%

# CONSUMER RESEARCH

## GENWORTH FINANCIAL LAUNCHES PROPRIETARY RESEARCH AMONGST SWEDISH CONSUMERS

Swedish consumers are looking for increased choice when it comes to mortgages – especially if it means taking a Top Loan..... according to consumers interviewed as part of a study conducted by Genworth Financial Mortgage Insurance. This creates an opportunity for any lender willing to innovate and introduce lifestyle products targeted at consumer needs.

As part of a Pan-European programme underlying Genworth's product development efforts, our Mortgage Insurance business recently conducted market research in Sweden.

The study focused on providing consumer-driven insights into the opportunities for the introduction of an alternative to the two-loan mortgage product that dominates the Swedish market.

The research used qualitative techniques to investigate consumer perceptions of the current mortgage market in Sweden, how they felt it met their needs and expectations, particularly probing to understand unmet needs and gaps in the market offering. Additionally the study introduced a number of new low deposit product concepts that were tested on the respondents to assess market interest.

Focus group sessions were conducted in both Stockholm and Gothenburg, amongst current owners (consumers who had recently gone through the entire home buying / mortgage process) and current intenders (consumers who were intending to buy, and were part way through the process). Consumers were recruited using a series of demographic criteria to ensure a sample that was representative of the Swedish Home Buying Population.

In addition, a number of selection criteria were added so that the groups comprised of consumers who would be 'in the market for' a low deposit mortgage product (i.e. consumers who had less than a 20 % deposit to put down on a property – or who would be interested in putting down less than 20 % deposit).

The study covered a number of discussion topics around the home buying and mortgage selection process. The main area of investigation included:

Swedish consumer's approach to the home buying process and what motivates them to considering purchase rather than rental

- Main sources of information and influence
- What sources of information and advice do Swedish consumers value most and why
- Levels of consumer knowledge with regards to available mortgage products
- Testing of new product concepts

### *Consumers Facing Unmet Needs*

### **Market Context**

The Swedish Market is dominated by a small number of banks and a uniform mortgage product offering which makes the market rigid and not especially consumer-centric. Swedish consumers – especially those that fall into the High Loan To Value category – face several unmet needs and our respondents voiced a clear dissatisfaction with the currently dominant top-bottom loan structure.

### **Swedish Consumers and The Home Buying Process**

Overall the home buying process can be complex and intimidating – especially for First Time Buyers. Swedish consumers tend to run in parallel the two processes of looking for their 'dream property', whilst trying to secure the best deal for funding.

# CONSUMER RESEARCH

## Information Sources and Spheres of Influence

When Swedish consumers look for information on buying a home and selecting a mortgage product, they prefer to take the advice from their own bank. Whilst most of the respondents reported referring to multiple sources including newspapers, Internet searches, home associations, real estate agents and family and friends, most respondents admitted gravitating towards the bank with which they have a pre-existing financial relationship, hoping for preferential rates or better service.

Feedback from consumers indicates that a widespread distrust exists among the public about both large and specialised banks. Distrust comes in several forms, related to issues such as service and reputation. Even though borrowers dislike banks, they still prioritise and prefer their own bank to others.

## Mortgage Products – What Swedish Consumers Value

Swedish consumers recognise the fact that the market is dominated by a two-loan product structure and their narrowed selection criteria is reflective of this situation. Selection criteria tend therefore to concentrate on Affordability of the Product, Lender Brand Equity, Trust and Strength of Existing Relationship.

## The One-Loan Lifestyle Mortgage ... A Real Opportunity

The current HLTV market in Sweden is rigid and not very consumer-centric. Consumers who are interested in HLTV options face several unmet needs that render the Swedish market ready for change and new product innovation within the HLTV category:

- Little choice and ability to shop around and negotiate for mortgages
- No clear understanding of the current top-bottom product and need for more education
- Complaints about high costs and lack of transparency associated with top loans

- Lack of real alternatives to the current product, other than exiting the market or accepting higher interest rates
- Inability for the consumer to be free and in charge of their own financial situation

We tested a number of products with our respondents – all based on a one loan structure – but with flexible options to suit different lifestyles. Concepts included a standard HLTV single loan mortgage, a mortgage with over and under payment features and a mortgage that made use of the borrowers savings to reduce the amount of interest paid on the mortgage loan.

All products generated a high level of interest with consumers who valued the increased financial flexibility and the fit with changing life stage needs.

## Innovation or Status Quo?

The study overwhelmingly showed that Swedish Consumers were facing substantial unmet needs when it came to mortgage product choice. Flexible mortgage products that took account of their changing funding needs over time were high on their agendas.

There is no doubt that new product introductions in any market require investment in terms of time, man hours and money – however, the first bank in the region to innovate and truly consider the consumer will undoubtedly reap the rewards ... not least in improved market share and brand image.

For further information about the full research findings, please contact Claes Billing, Managing Director Nordic Region, Genworth Financial Mortgage Insurance Europe +46 8 559 501 15.

*Flexible Options Have High Consumer Appeal*

# BASEL II - CONSEQUENCES AND OPPORTUNITIES

## *European Banks Face a Number of Challenges*

### **BACKGROUND TO BASEL, THE THREE PILLARS**

During the five years that have passed since the Basel Committee for Banking Supervision first introduced it, the Basel II Capital Accord has developed into an extensive and complex regulatory framework that will create a number of challenges for banks in Europe. While Basel 1 addressed only market risk and had a basic approach to credit risk, Basel II will substantially change the way in which banks manage credit risk and also require the Banks to hold capital against operational risk. Basel II launches a new concept with a three-pillar structure to replace the old "one size fits all" principle that governed Basel 1. An overall principle for the new regulatory framework is to align regulatory requirements with principles of risk management and economic capital, that is, banks should hold capital that is aligned with the "true" risks they face. This development should also be seen as an answer to the development in the industry during the past decade where the progress in areas such as credit-rating, economic capital, risk-based pricing and credit risk transfer technology have created a need for modification of the regulatory framework.

The first pillar specifies minimum capital requirements for bank's exposure to credit risk, market risk and operational risk. The Basel committee states that "the new framework provides a 'continuum' of approaches from basic to advanced methodologies for the measurement of both credit risk and operational risk in determining capital levels".

Pillar II sets out the process for Supervisory Review of capital adequacy. Supervisors should try to intervene to prevent capital from falling below minimum levels but should also expect banks to operate above minimum capital ratios. It also defines specific responsibilities for the board and the senior management of banks in order to reinforce internal controls.

Pillar III is intended to create market discipline through enhanced disclosure of the bank's credit risk parameters and capital structure. The result will be increased comparability and transparency in the banking industry.

Most major banks are currently in the process of finalizing their implementation projects.

The new standard represents a global-scale revolution for banks. Loan risk management policies will become critical, not only because of their impact on profits, but also as a result of their impact on the regulatory capital requirements.

Within the Basel II standard, residential mortgage lending has received special attention, as this type of loan stands to benefit the most from the new capital requirement rules. This article focuses on the opportunities and challenges brought by Basel II in the residential mortgage-lending sector and will cover in particular the following points:

- Standard method: a competitive disadvantage with respect to the internal rating system.
- Commercial benefits stemming from better Risk Management processes.
- Benefits stemming from the externalization of loan-related risk.
- Difficulties in implementing an internal rating-based system.

Standard method: a competitive disadvantage with respect to the internal rating system

As noted, Basel II allows (retail) banks to choose one of two approaches for capital calculation: the standard method and that based on internal ratings. The first allows continuity with respect to the current approach while allowing, for residential mortgages, an immediate decrease in capital requirements. The weighting of assets is reduced from the current 50% to 35%, provided that there is "a significant margin of additional guarantee on the amount of the loan based on stringent evaluation rules". Furthermore, the introduction

## *Residential Mortgage Lending Receives Special Attention*

# BASEL II - CONSEQUENCES AND OPPORTUNITIES

## *Better Loan Management Practices Result in Capital Related Advantages*

of integrated guarantees (sureties policies, Mortgage Insurance, etc.) may allow loans above the 80% LTV threshold to obtain a weighting of 35%. However this is still to be decided by regulators in the respective countries. In terms of regulatory capital requirements, for the majority of residential mortgages the reduction of the asset weighting could, in concrete terms, allow a reduction from the current 4% of capital to 2.8% with respect to the existing loan portfolio, i.e., a reduction of 30%.

With the (advanced) internal rating-based method (IRBA), it may be possible to obtain an even larger reduction in the capital requirements. The IRB method does not provide standard weighting coefficients, but requires banks to calculate such weightings on the basis of their own specific risk indicators, in particular the Probability of Default (PD), Loss Given Default (LGD), and Exposure At Default (EAD). The Basel II standard provides the formula to be used to calculate the capital requirements on the basis of the bank's risk indicators. The result is that banks with appropriate Risk Management processes in the residential mortgage business sector can obtain significant advantages with respect to banks that adopt the standard method.

As an example, for a bank with a PD of 0.35% and an LGD of 25%, minimum capital requirements of about 1.2% will be requested, which means less than half of that required for a bank using the standard method. A bank that uses the IRB method could obtain commercial superiority from such capital advantages given that the lower capital requirements could translate into lower interest rates for customers. To reach the breakeven point between the two methods of calculation, it would be necessary for an IRBA bank to have, for example, a PD of 0.5% and an LGD of 45%, which appear to be very high for banks with appropriate loan policies.

## **The commercial benefits resulting from better Risk Management processes**

Another clear outcome of the new capital requirement rules is that, in the comparison of banks using the internal ratings-based method, better loan acceptance and management policies will result in significant capital-related advantages and, consequently, it will be possible to transpose such advantages into better commercial performance.

Table 1 illustrates the links between loan quality ratings and minimum capital requirements. As shown, the minimum capital requirement for Bank 1 is 45% lower than that for Bank 2 and more than 60% less than that of Bank 3. Assuming equal prices for the three banks, Bank 1 could therefore have a mortgage ROE more than 80% higher than that for Bank 2 and more than 170% higher than for Bank 3. Alternatively, assuming equal ROE values, Bank 1 could reduce its mortgage interest rates to obtain a significant increase in customer turnover.

Today, in the pre-Basel II era, capital requirements for banks in the area of residential mortgage lending are totally independent of Risk Management practices. With Basel II, the loan management processes will become crucial, not only because of their impact on asset quality and on the level of profit-and-loss provisions/adjustments, but also because of the effect they have on capital levels and commercial competitiveness. It follows that banks with better loan granting processes (for example, with a better scoring system), more professional real-estate evaluation systems, and better organization of recuperation procedures will be those best placed to grow and win market shares.

# BASEL II - CONSEQUENCES AND OPPORTUNITIES

## *Risk Transfer to Third Party can Lower Capital Requirements*

### Benefits resulting from risk externalization

Another result of Basel II is that the introduction of risk mitigation techniques that allow the transfer of loan risks to a third party, within the framework of the IRB method, will result in lower capital requirements. This can be illustrated using an example. Let's imagine that a bank grants a mortgage of € 100,000 with a Probability of Default of 0.3% and with a Loss Given Default of 40%, corresponding to €40,000.

Table 1

	RISK INDICATORS		
	PD	LGD	% capital
<b>BANK 1</b>	0.2%	15%	0.48%
<b>BANK 2</b>	0.3%	20%	0.87%
<b>BANK 3</b>	0.4%	25%	1.33%

If the bank stipulates an insurance guarantee (for example, Mortgage Insurance) that allows it to receive an indemnity of € 20,000 in the event of default, the LGD is halved. Given the formula for calculating residential mortgage capital, the capital requirements (1.73% in the absence of integrated guarantees) are reduced to 0.87% with a guarantee.

Nevertheless, there are some caveats. Firstly, the company that provides the insurance guarantee must have high creditworthiness. An A- rating is recommended as a minimum requirement. Secondly, if the bank is exposed to a counter-party risk with regard to the guarantor, within the framework of the IRB method, the full benefits of the guarantee will not be recognized. In the example above, the bank may not count on 100% payment from the guarantor in the event of default, but should consider only part of it (for example 90%) depending on the creditworthiness of the company that supplies the guarantee. In summary, the guarantee must comply with certain essential requirements in order to be recognized: for example, it must be documented in writing, it must not be cancellable, and it must be valid for judicial settlement.

It is therefore obvious that, when Basel II enters into force, a new relationship will be forged between banks and companies that share the loan risk. The existence of insurance guarantees will, in addition to the traditional profit-and-loss benefits (less provisions/adjustments) and reductions of the volatility of losses on receivables, in particular, also allow benefits in terms of reducing required capital.

### The difficulty of implementing an internal ratings-based system

Up until now, we have discussed the opportunities arising from the introduction of the new capital requirement rules for residential mortgage lending. There are, nevertheless, certain difficulties associated above all to implementing an IRB model. These difficulties result from the minimum requirements defined by the Basel Committee for an internal ratings-based system to be considered valid. The problems related to the appropriateness of information systems and the availability of appropriate verification mechanisms will not be examined in this communication (this would require a more detailed analysis), and we will limit ourselves to four important critical points that are particularly relevant to the residential mortgage market.

The first relates to the factors used to sub-categorize the mortgage portfolio. For example, it is clear that the Probability of Default (PD) is linked to factors such as:

- Loan-to-Value ratio: experience in all markets demonstrates that the lower is the initial deposit paid by the customer for the acquisition of real estate, the lower is his incentive to honor the payments in the event that difficulties arise.
- Product type: variable interest rates, for example, are higher risk than fixed interest rates; open-repayment mortgages are higher risk than constant-repayment amortization schemes.

# BASEL II - CONSEQUENCES AND OPPORTUNITIES

- Type of borrower: self-employed persons, for example, are associated with higher risks than employees; region of residence also has an impact on expected PD.
- Mortgage maturity: insolvencies go through a peak between the third and fifth years. It follows that a mortgage that has been solvent for ten years will not be assigned the same PD as a mortgage granted three years ago.

The first three factors are typically acquired by scoring systems that assign a probability of default to the mortgage when it is first granted. The fourth factor requires that the PD be updated over the lifetime of the mortgage. Even with respect to Loss Given Default (LGD), sub-categorization can be clearly seen given the dependency on factors such as Loan-to-Value ratio and the geographical area of the real estate (the effectiveness of the courts varies from region to region).

Effective sub-categorization will allow, on the one hand, a more precise estimation of the minimum required capital, and on the other hand will provide a more valuable input for pricing policy, in that lower-risk product/borrower sub-categories can be offered better conditions.

Another critical point is the capability to estimate regulatory capital in relation to new types of product, for which there is no internal risk data. For example, over the last few years many banks have launched mortgage loans with high Loan-to-Value ratios and insolvency and losses data in their possession will be insufficient for a long time to come, or even completely absent. Also in this case, comparison with appropriate external data sources and the use of the stress test will be critical for determining appropriate levels of minimum capital requirements.

## Conclusions

Basel II will represent an essential focal point for banks at a global level. In the residential mortgage market, those banks with the best risk assimilation and management will reap significant benefits, not only in terms of asset quality, but also in terms of profitability and commercial performance.

Generally, Nordic banks are favoured by the rules mainly due to their relatively large exposures to the retail sector. The previous Nordic banking crisis also exists in many bankers minds and that has also held back the aggressive volume strategies towards the corporate segment in the last decade. The major hits towards the IT-sector seem to have been taken mostly by venture capitalists.

### Organisation

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#### Recommended literature:

Credit Risk Transfer, Study by the joint forum,  
Basel Bank of International settlements

Basel Committee on Banking Supervision,  
International Convergence on Capital  
Measurement and Capital Standards, A revised  
framework, June 2004

Nordic banks: Swedish mortgage market study,  
Goldman Sachs Global Investment Research,  
September 2004

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