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Regulatory Regime Change in the Swedish Residential Mortgage Market

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In this essay, I analyze the Swedish residential mortgage market regulations during the post–World War II era, with an emphasis on the regulatory regime change of the mid-1980s. The most significant changes were directed toward abolishing regulations. More players could enter the market, creating a need for regulation to cover a larger area of finance. The government had previously provided strict incentives for following the rules, but the changes meant that the government let the market find its own way to provide incentives. Thus, the motivating structure for the government, borrowers, and lenders changed from strictly government-controlled to market-controlled, from rigidly regulated to deregulated.

The turmoil of the subprime mortgage crisis makes it clear that financially we are living in a global world. Events in one part of the residential mortgage market in the United States send shockwaves around the earth. Many question whether different regulations could have prevented the crisis. It may be time to rethink the financial markets' regulatory regimes.

In the process of rethinking, it is crucial to investigate different regulatory regimes to try to avoid repeating the same mistakes in the future. In this essay, I review regulations in the Swedish residential mortgage market for freestanding and semi-detached houses.[1] We can learn from analyzing Swedish regulatory changes even though Sweden is

[1] Henceforth, the residential mortgage market.

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only a small market. In fact, the basic functions of regulatory regimes are the same in small and large countries.

Therefore, my aim in this essay is to analyze the regulations created for the Swedish residential mortgage market since World War II, with a special focus on changes that appeared in the mid-1980s. Is it possible to call it a regulatory regime change, according to, for example, David T. Llewellyn's criteria? If so, must the changes in regulations affect the financial actors and the residential mortgage market as a whole?

Regime Changes in the Regulations

Nations continually revise regulations with changing circumstances, but regime changes comprise much more than simple changes in regulations. They reflect an alteration in the underlying purpose of the regulations: for example, regulations switch from being a government tool for directing the economy, in accordance with Keynesian economic theories, to a tool for a well-functioning market, in accordance with neo-classical economic theory. Regime changes begin with questioning existing regulations and end by shifting the whole system of regulations. To count as a regime change, it is necessary that the changes affect most parts of the regulatory system.

According to David T. Llewellyn, the rules established by regulatory agencies constitute one important component of a regulatory regime. These rules often arise from informal institutions; thus, the actors have often already tested and approved them, forming rules to encourage safe and secure management of banks and other financial institutions. For example, capital cover rate rules ensure that companies have enough capital in case of market disturbances. They regulate the establishment of banks and what the various actors are allowed to do.[2]

Both Llewellyn and Julia Black emphasize the qualities of well-functioning regulations: they should be precise enough to cover everything needed, but simple enough to allow ease of use. Therefore, it is necessary to consider the relative importance of precision and simplicity. Precision makes it easier to enforce regulations, but can make the system far more rigid.[3] We also need to consider structural differences in creating regulations. A regulation that works effectively for one player will not necessarily fit another player in the market.

The agencies that monitor, supervise, issue licenses, and thereby control the establishment are also a factor. Monitoring has to be effective so the regulations remain useful.[4] Enron is one example of a monitoring and supervision system not working; regulators had double roles and

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[2] David T. Llewellyn, "A Regulatory Regime for Financial Stability," Oesterreichische Nationalbank Working Paper no. 48 (2001).

[3] Ibid.; Julia Black, " 'Which Arrow?' Rule Type and Regulatory Policy," *Public Law* (1995), 94-117.

[4] Llewellyn, "A Regulatory Regime for Financial Stability."

conflicting positions and, therefore, no incentive to ensure that the company followed the rules. The regulatory regime must give players incentives to follow the rules and tools to avoid moral hazard, the undesirable behavior of a single person or group within the financial institution.

According to Llewellyn, market discipline is an important part of a regulatory regime, which should work to enhance market discipline and ensure monitoring.[5] It can work through rating institutions and other financial instruments that lower the risk in this area. One aspect of market discipline, for example, is providing data to limit problems with asymmetric information.[6]

Another important area for a regulatory regime is the ability to intervene in the case of bank failure, to minimize negative effects on the financial system. Here there is a differentiation between letting an ineffective company go bankrupt to achieve a more effective system (so-called creative destruction), and saving a company to prevent the effects of the bankruptcy from infecting the entire financial system.[7] Included is the role of the central bank as the lender of last resort for financial institutions in need.

The regulatory regime also plays a role in the internal corporate governance arrangements of financial institutions. For example, stockowners have incentives to increase risk-taking in order to increase their profits; the regulatory regime prevents risky behavior and thus works as a source of strong corporate governance. The regime punishes misuses of the system—for example, insider trading.[8]

Another important function of a regulatory regime is to serve as the motivating structure for government, borrowers, and lenders.[9] The motivating structure provides the incentives in the regulatory regime and covers everything from the external political, social, and economic influences that affect the system to the players inside the system. It reflects the underlying purpose of the regulations and is an important determinant of the direction the regulations take.

This regime theory was written for the financial markets as whole, not only for the residential mortgage market. Nevertheless, we can apply the theory to the residential mortgage market, albeit with a different emphasis. Some aspects of regulatory regime theory are more important than others to the residential mortgage market—for example, the motivating structure, which controls the priority of the residential mortgage market relative to other financial market areas.

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[5] Ibid.

[6] Ibid. ; Robert J. Shiller, *The Subprime Solution: How Today's Global Financial Crisis Happened, and What To Do about It* (Princeton, N.J., 2008).

[7] Llewellyn, "A Regulatory Regime for Financial Stability."

[8] Ibid.

[9] Ibid.

Another important characteristic of the residential mortgage market is the unequal relationship between lenders and borrowers. There are a few very large lenders and many small borrowers. This inequity necessitates protecting the weaker partner (the borrower), and monitoring and supervision become an important part of the regulatory regime. Individual borrowers do not have enough power or information to protect their interests or to affect the market; it also follows that individual borrowers do not disrupt the system, even if they do not make their mortgage payments.

Similarly, as the players create regulations, the regulations also affect the players within and outside the system. There are many players, in addition to lenders and borrowers, that dramatically affect the residential mortgage market, including government, insurance companies, and other financial institutions outside this market, both nationally and globally. Regulations determine the players' positions relative to each other, but the players are also the creators of the rules and structures.[10]

Regulations in Sweden

After World War II, an important part of the creation of the Swedish welfare state was good housing for everyone. The demand for dwellings increased, because of population growth and urbanization, making it important to increase the supply of houses. Most people's dream was to have a freestanding or semi-detached house. [11]

To make this possible, a healthy credit system with low interest rates was of utmost importance; however, low interest rates threatened to increase the demand for credit. Consequently, the credit market needed to control loan limits and direct the existing credit to prioritized areas such as the residential mortgage market.[12]

Both the adoption of new regulations and the enhancement of existing regulations (in an attempt to control the credit market) characterized this period. Currency controls were introduced as a wartime policy to control the flow of currency across the borders; they allowed the central bank of Sweden, Riksbanken, to make decisions about all import and export of currency.[13] However, even after the war had ended the government viewed

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[10] Stefan Tengblad, "Aktörer och institutionell teori" [Actors and Institutional Theory], Working Paper (Göteborg, 2006).

[11] Lars Se Fälting, *Småhusfinansiering: en studie av kommunens, statens och enskilda aktörers riskhantering i Nyköping, 1904-1948* [Small-House Financing: A Study of Municipal, State and Individual Actors in Risk Management, Nyköping, 1904-1948] (Uppsala, 2001).

[12] Ingemar Hansson and Bengt Turner, *Bostäder och samhällsekonomi* [Housing and Economics] (Lund, 1977); Ralph Johansson and Björn Karlberg, *Bostadspolitiken* [Housing Policy] (Stockholm, 1979); Karin Kock, *Kreditmarknad och räntepolitik, 1924-1958* [Credit and Interest Rate Policy, 1924-1958], vol. 2 (Stockholm, 1962).

[13] SFS [The Swedish Code of Statutes] 1939:350 Valutalag [Law of Currency].

these regulations as too important to rescind. Extended year after year, in 1958 they became law. Thereafter, the law was used as necessary to reach the goals established by the central bank for monetary policies, or for the state's solvency with foreign countries.[14] In the mid-1970s, there was an addition that considered industry and employment goals.[15] These regulations required permission from Riksbanken to borrow money from abroad, and a decrease in credit grants followed.

Together with enhancing the currency control introduced in the early 1950s, a number of regulations aimed at limiting the granting of credit were introduced. They also directed the remaining flow of credit to the prioritized sectors of the economy, among them building real estate. The regulations included the control of both banks' deposit rates and banks' lending interest rates. Riksbanken determined the highest and lowest interest rates, as well as the specific interest rates for different purposes; as a result, residential mortgage loans were offered at lower interest rates than many other forms of credit.[16]

These interest rate controls were possible only because currency control stopped the flow of credit across the border, thereby forcing the market and its actors to follow Riksbanken's restrictions. The argument was that the interest rate controls were necessary because otherwise currency controls would increase the interest rates higher than desirable. It was also undesirable to use interest rates to fight inflation, which ran the risk of creating higher unemployment.[17] Riksbanken's interventions included an emission control stating that the release of new bonds required Riksbanken's permission.[18] Furthermore, special liquidity quotas were introduced, requiring the banks to hold enough capital in the form of currency, state bonds, and other gilt-edged securities to cover their debts. These liquidity quotas were higher than the capital cover rate regulated by the banking laws (*bankrörelselagen*). Moreover, the quotas changed with the Swedish state's demand for capital.[19] Beginning in 1955, the so-called lending ceilings, which Riksbanken set concerning how much each actor

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[14] SFS 1974:458, addition to SFS 1939:350 Valutalag.

[15] Ibid.

[16] SFS 1974:922, addition to SFS 1939:350 Valutalag.

[17] Kock, *Kreditmarknad och räntepolitik*, 2: 398; Lars Nyberg, Steffan Viotti et al., *Penningmarknaden* [Money Markets] (Stockholm, 2006), 254; Lars Werin et al., eds., *Från räntereglering till inflationsnorm: det finansiella systemet och Riksbankens politik, 1945-1990* [From Interest Marketing to Inflation Norm: The Financial System and the Riksbank's Policy, 1945-1990] (Stockholm, 1993), 298.

[18] Werin et al., *Från räntereglering till inflationsnorm*, 298; SFS 1974:922 Lag om kreditpolitiska medel [Law of Credit Policy].

[19] Kock, *Kreditmarknad och räntepolitik,* 2: 400.

could loan, also controlled credit amounts. Thus, Riksbanken directly controlled the flow of credit. [20]

With the introduction of these regulations, negotiations started between Riksbanken and the insurance companies regarding the placement of funds. Riksbanken wanted the insurance companies' funds placed in prioritized areas, whereas the insurance companies wanted to place their funds in high-yield areas. They tried voluntary agreements, but these were both hard to introduce and hard to enforce. As a result, a law was introduced in 1962 concerning placement quotas and government retirement funds, the so-called AP funds; the private insurance companies were thereafter obligated to place 75 percent of their funds in prioritized areas such as residential buildings.[21] In addition, the legislation could force banks to increase their lending for housing during the building phase (building credits).[22] Altogether, this led to the subordination of monetary policies to housing politics in order to supply the housing sector with credits. An important part of housing policy was the so-called million program. The idea behind this project was to build one million apartments from 1965 to 1974.[23] The financial market was highly regulated during this time, which granted political leaders freedom to protect the public sector and the prioritized area of homebuilding by offering favorable loans, as well as by creating some protection from disturbances in the currency market.

In addition, earlier regulations continued to operate during this period. For example, it was necessary to consider whether the market was large enough to support another bank when granting a bank charter. Furthermore, banks could not engage in compound trading—for example, working as insurance companies.

Other, smaller adjustments in the regulations occurred during this time, but the regulations mentioned here were the most important and the ones most characteristic of this period.

Deregulation

In the mid-1970s, there was criticism that the rigid system of regulations had lost its power, and calls arose to transform the regulations to better fit the new political regime. For a more effective economy, the market, not the state, should be in charge. During this time, investors found new ways around the credit system through loopholes in the regulations, and a so-

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[20] Werin et al., *Från räntereglering till inflationsnorm;* Mats Larsson, Mikael Lönnborg, and Sven-Erik Svärd, *Den svenska försäkringsmodellens uppgång och fall* [The Swedish Insurance Model's Rise and Fall] (Stockholm, 2005), 82.

[21] Larsson, Lönnborg, and Svärd, *Den svenska försäkringsmodellens uppgång och fall.*

[22] SFS 1974:922, addition to SFS 1939:350 Valutalag.

[23] Werin et al., *Från räntereglering till inflationsnorm,* 165-66.

called grey market for credits emerged.[24] The instruments of money and credit policies were abolished during this time of deregulation (see Table 1).

TABLE 1
Instruments for Money and Credit Policies

Regulations	**Year Introduced**	**Year Abolished**
Restriction on placement of funds abroad	1939	1987-89
Other currency regulations	1939	1989
Regulations on banks' deposit rate	1951	1978
Regulation of banks' lending rate	1951	1985
Emission control	1951	1991
Liquidity quotas	1953	1983
Lending ceiling	1955	1985
Placement quotas for insurance companies and AP funds	1962	1986
Regulations based on need for banks to give bank charters	*	1990
Compound trading forbidden	*	1991
Index bonds	*	1991
Regulation on transfers of payments	*	1993

Sources: Johan A. Lybeck, *Den svenska finansiella sektorns utveckling i modern tid* [The Development of the Swedish Financial Sector in Modern Times] (Stockholm, 1999), vol. A: 123; Mats Bergman, "Konkurrensen på bankmarknaden-betalningsförmedling och villkor för nya aktörer" [Competition in the Banking Market—Money and Conditions for New Actors], *Konkurrensverkets rapportserie 1999* [FCA Report Series], 28; SFS [The Swedish Code of Statutes].

The abolition of the regulation of the banks' deposit rates in 1978 allowed banks to influence deposit amounts and thus the amount of capital for lending. Beginning in 1985, banks controlled the lending rate and the total amount of lending. Riksbanken abolished all restrictions regarding lending during the fall of 1985, which led to an expansion of credit from 1985 to 1990. This was likely the main cause of bank failures and the Swedish bank crisis in the early 1990s.

One of the more important deregulations for the residential market was the opening of the bond market for residential bonds in 1986. Thereafter, all lending would be in full competition and at market rates.[25] At the

[24] Ibid.

[25] Sveriges Bostadsfinansieringsaktiebolag [Swedish Housing Finance Corporation] (hereafter SBAB), Annual Report 1987, p. 4; 1988, p. 4.

same time (1986-1987), placement quotas for the AP funds and the insurance companies were abolished. They now could place their capital where it had the highest rate of return. Consequently, the residential mortgage market lost its privileged position, but new possibilities for financing emerged.

During 1989, further deregulation changed the conditions for banks' lending with the abolition of currency regulations. As a result, foreign investors started investing capital in the Swedish banking system, and Swedish financial institutions could now release capital outside Sweden.[26]

In addition to these earlier deregulations, two others were of great concern for access to the residential mortgage market. The first was the abolition of the requirement that a prospective bank had to establish that the market was large enough for a new bank before receiving a charter (although, until 1990, the Swedish government could stop the establishment if there was a risk of overheating the market). This change opened up a new form of competition. The second important deregulation was the end of the ban on compound trading. Banks could compete with insurance companies for retirement funds, and insurance companies could give mortgages directly, rather than being forced to work through a third party.

The direct effect of these deregulations was an increase in the amount of credit and a booming economy—until 1990, when the recession began. Several real estate companies went bankrupt, and the crisis in the real estate business spread to the financial market. In September 1992, currency speculation occurred against the Swedish krona, and Riksbanken increased the repurchase rate (repo) to 500 percent to defend the fixed exchange rate. When this did not succeed, Riksbanken had to let the exchange rate float. Because of the crisis, Sweden's national debt and unemployment increased, and GDP (Gross Domestic Product) decreased for several years.[27] The government also had to act as a lender of last resort to most of the Swedish banks to save the financial system.[28] In connection with the crisis, Riksbanken would no longer occupy itself with questions of unemployment, industry, or housing politics; its sole goal was to keep inflation steady around two percent.[29]

The residential mortgage market continued to be regulated, but in a different way. The view changed from regulation as a tool for the government to control the economy, to a self-regulating market as providing the necessary supervision through various financial instruments and rating systems. Nevertheless, there were still laws to control

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[26] SBAB Annual Report 1989, p. 4.

[27] Lars Hörngren and Hans Lindberg, "The Struggle to Turn the Swedish Krona into a Hard Currency," Sveriges Riksbank Arbetsrapport No. 8 (1993).

[28] Mats Larsson and Hans Sjögren, *Vägen till och från bankkrisen: svenska banksystemets förändring, 1969-94* [The Road to and from the Banking Crisis: Swedish Banking System Change, 1969-94] (Stockholm, 1995), 201.

[29] The main web page of Riksbanken. URL: http://www.riksbank.se.

establishments, mergers, and liquidations. Swedish financial inspectors supervised and carried out the strictly regulated revisions of ongoing financial activities. Regulations also controlled the relations between subsidiary and parent companies, thus playing the role of internal corporate governance among the financial institutions.[30] The biggest differences compared to the period before deregulation were the opening of the market to new actors and the emergence of new possibilities for financing.

Actors in the Residential Mortgage Market, 1950-1985

Government behavior vis-à-vis the actors in the residential mortgage market changed over time. Between 1950 and the mid-1980s, the government chose to protect the actors, whereas from around 1985 until 2005 the government let the market work under full competition. The main argument for protecting the actors was to prevent a crisis if they went bankrupt, which could lead to severe losses for the national economy. However, the arguments for abandoning the protective system were also about losses to the national economy: allowing ineffective companies to go bankrupt would make the market more successful, to the benefit of society as a whole.[31]

In the early 1950s, Swedish regulations for financing house purchases protected the actors. Every mortgage had three different parts: a first mortgage loan, the government mortgage loan, and a top-up loan, with different actors financing each part (see Figure 1). Introduced in 1933, government mortgage loans were enhanced in 1940 to include larger grant amounts. This was part of a plan to increase the building of residential houses. The building rate was still too slow, however, and beginning in 1941, the government adopted contingent interest-rate subventions and interest-rate guarantees. The first mortgage had an interest rate of .5 percent; if the market increased the interest rate above that, the government would decrease its loan interest rate proportionally (at that point, the government loan rate was 4.5 percent).[32] Furthermore, the interest-rate guarantee covered the first mortgage and guaranteed lenders that homebuyers paid their mortgage before the government mortgage.[33] The loans approved for interest-rate guarantees were made primarily by

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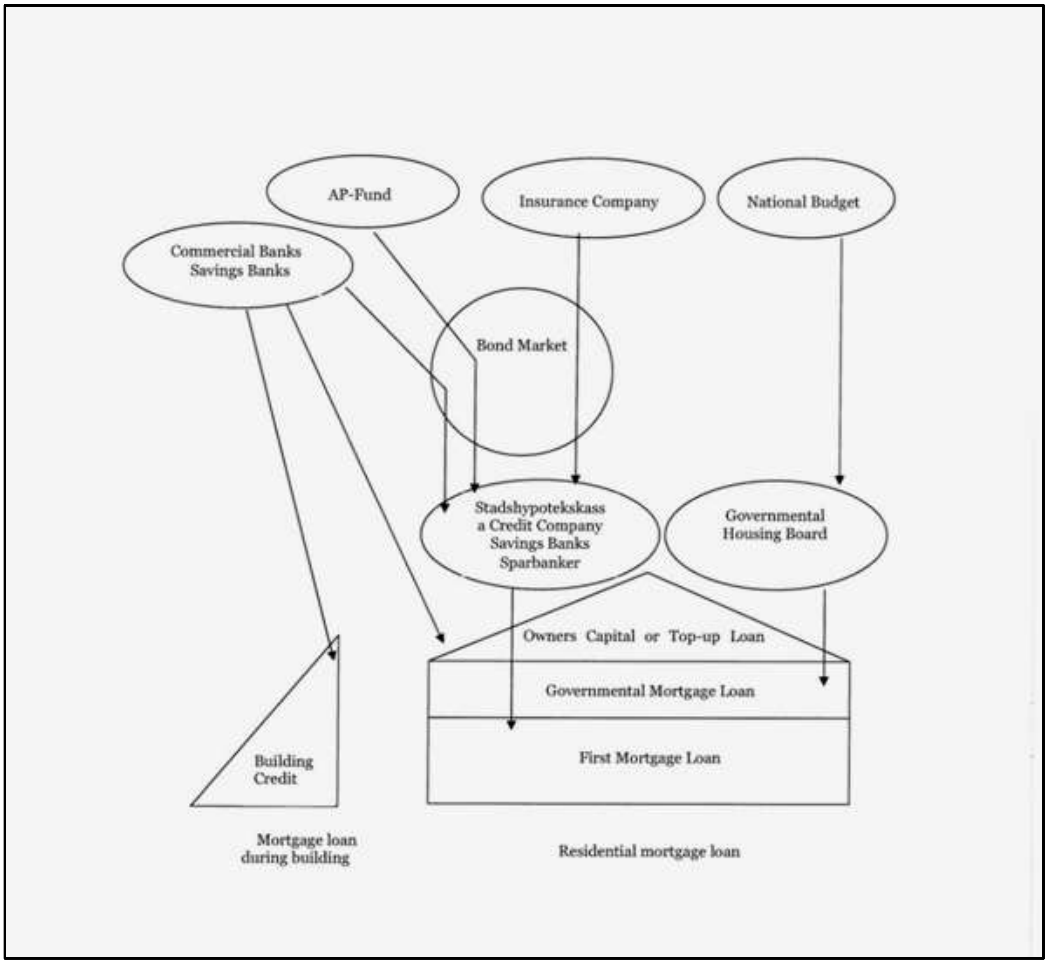
[30] See, for example, SFS 1987:617 Bankrörelselag [Law of Banking Business]; SFS 1987:621 Lag om införande av ny banklagsstiftning [Law of Introducing New Bank Legislation]; SFS 1995:1570 Lag om medlemsbanker [Law of Members Banks]; SFS 1992:1631[Lag om lämplighetsprövning av större ägare i bankaktiebolag [Law of suitability test of larger owner of joint-stock banks].

[31] Raghuram Rajan and Luigi Zingales, *Saving Capitalism from the Capitalists: Unleashing the Power of Financial Markets to Create Wealth and Spread Opportunity* (New York, 2003).

[32] Kock, *Kreditmarknad och räntepolitik,* vol. 2.

[33] Ibid., 290.

FIGURE 1
The Financing of the Residential Mortgage Market, 1950-1985



Source: Revision of *Bostads-och byggnadsstatistisk årsbok* [Housing and Building Statistical Yearbook], 1979.

credit companies, savings banks, and *Stadshypotekskassan* (a mortgage institution).[34] This excluded commercial banks from directly loaning for residential building, because almost all financing of new homes and home renovations was by interest-rate guaranteed loans.[35] This protected banks from competition, but strictly limited their actions because they could not expand their business into new areas.

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[34] Ibid., 292.

[35] SBAB Annual Report 1987, p. 2; 1988, p. 2; 1989, p. 2; 1990, p. 2; Hans Sjögren, ed., *I takt och otakt med tiden: Stadshypotek mellan marknad och politik* [In Step and Out of Step with Time: Stadshypotek between Market and Policy] (Stockholm, 2002).

153; Kock, *Kreditmarknad och räntepolitik,* 2: 290.

Approval for government mortgage loans required that houses be built to certain standards, although the government could influence building in what politicians perceived to be the right direction. For example, the standards included how big the house should be, and these limits could be set neither too big nor too small.[36]

Four groups financed the different parts of the loan: the government, the banks (both commercial and savings), the AP funds, and the insurance companies. The national budget financed the government mortgage loan through the government housing board. The commercial and savings banks financed the first mortgage loans through *Stadshypotekskassan*, credit companies, and smaller savings banks (*enskilda sparbanker*). The AP funds and the insurance companies' placement duties led to a large part of their capital being placed in first mortgage loans through the bond market, together with capital from the commercial banks (see Figure 1). Currency regulation limited the AP fund's and the insurance companies' international investments; as a result, they had few areas outside the residential market in which to invest. In addition to financing the first mortgage loans, these commercial and savings banks also directly financed building credits and some of the top-up loans. Building credit financed home construction, and when the house was finished, the commercial banks were supposed to replace the building loan with credit from the mortgage institutions. The building credit often served as mortgage takers' primary loans for years, however; the commercial banks did not have incentives to replace the loans, and the borrower often had problems entering the market of mortgage institutions if there was a lack of credit, or if the lenders' quotas were full.

The commercial banks were above all the big banks, Handelsbanken, Götabanken, and Skandinaviska banken,which merged with Stockholms Enskilda Bank under the name SE-banken (present-day SEB).[37] In addition, there were "provisional banks," which were often local banks of medium size, with a considerably smaller total balance sheet than the big banks. Besides these, there were many local cooperative banks and independent savings banks similar in size to the provisional banks. During this time, the government granted no bank charters to banks as large as the big banks, except for the government's PK Bank in 1974.[38]

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[36] SFS 1967:552 Kungl. Maj:ts Bostads-lånekungörelse [The Royal Highness Residential Mortgage Edict].

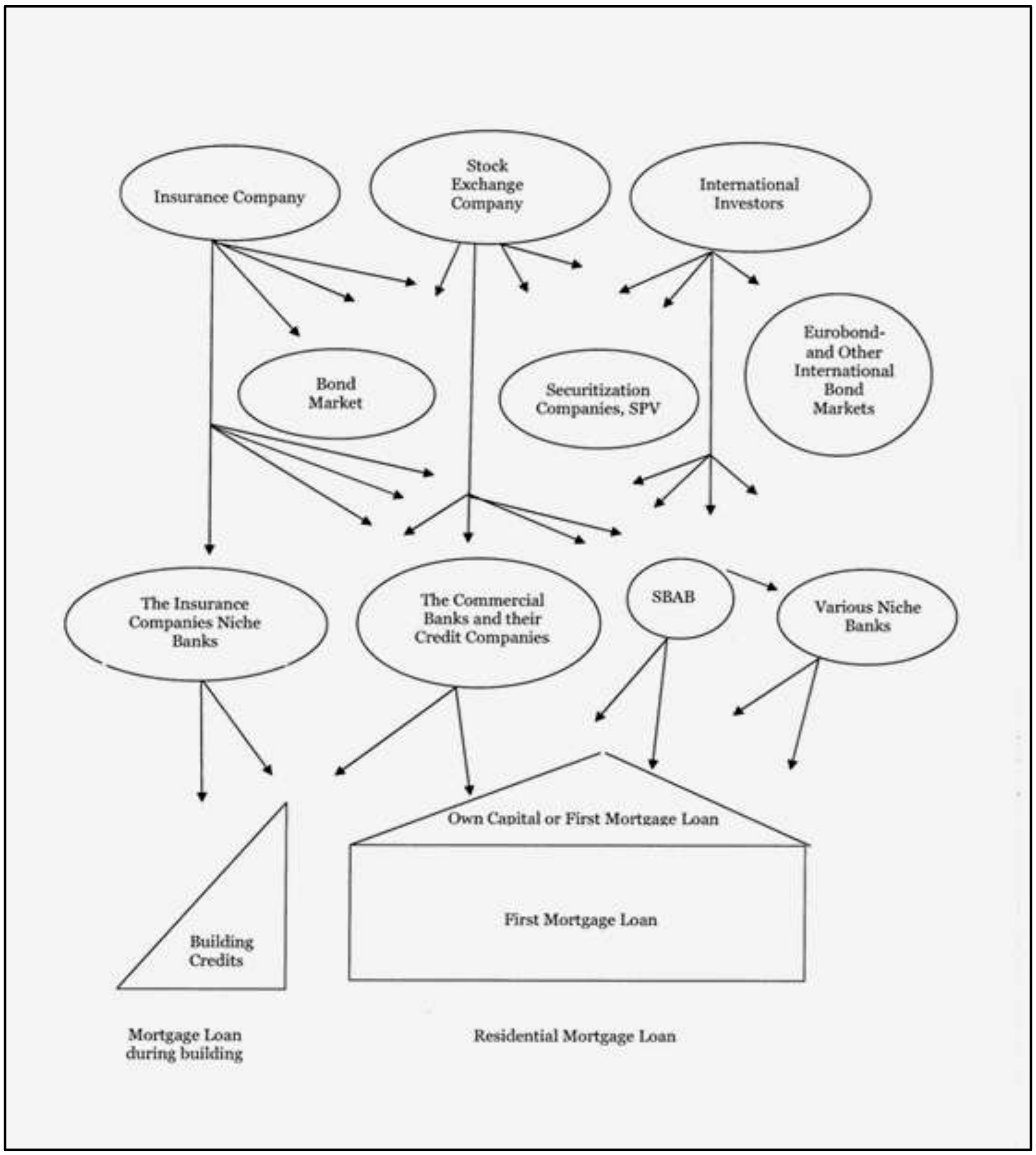
[37] Mats Bergman, "Konkurrensen på bankmarknaden-betalningsförmedling och villkor för nya aktörer" [Competition in the Banking Market—Money and Conditions for New Actors], *Konkurrensverkets rapportserie 1999* [FCA Report Series]: 2; SCB *Bostads-och byggnadsstatistisk årsbok* [Sweden's Housing and Building Statistical Yearbook], 1979, p. 136.

[38] SCB *Bostads-och byggnadsstatistisk årsbok* 1979, p. 27-30.

Actors in the Residential Mortgage Market, 1985-2005

Deregulation opened the residential mortgage market to a new form of financing and to new actors. Financing could come through the domestic or international bond markets, securitization, or directly from the lead financiers. As during earlier times, these leading financiers included insurance companies and AP funds, but now other stock exchange companies and international investors could participate (see Figure 2). However, financing was voluntary, not forced by placement quotas.

FIGURE 2
The Financing of the Residential Mortgage Market, ca. 1990-2005



Source: The author.

Mortgage loans no longer had separate parts; a single actor loaned the whole amount (see Figure 2). This actor, the direct lender, could be a commercial bank and its credit company, SBAB (the government-owned credit company), an insurance company, or a niche bank. These lenders became less common after deregulation, however, rather than more common, even though deregulation had eased entry into both the financial and residential mortgage markets.

Handelsbanken bought Skånska Banken in 1990; at the same time, the government-owned PK-banken bought the privately owned Nordbanken. Furthermore, Gota Bank emerged from the constellation of Göta-banken, Skaraborgsbanken, and Wermlandsbanken. Following the early 1990s' financial crisis, Gota Bank bought Bohusbanken and Svea Banken before the Nordbanken takeover in 1994.

Eleven of the largest savings banks founded Sparbanksgruppen AB in 1991 and later merged with Sparbankernas Bank under the name Sparbanken Sverige. During 1997, a merger occurred between Sparbanken Sverige and the Cooperative Bank, and Föreningssparbanken (now Swedbank) was founded. During the same year, Handelsbanken bought Stadshypotek, which included Stadshypotek Bank; Nordbanken merged with the Finnish bank Merita Bank; the Danish Bank, den Danske Bank, bought Östgöta Enskilda Bank; and SE-banken (now SEB) bought the insurance company Trygg-Hansa and the subsidiary Trygg-banken.[39]

These fusions meant that, in the mid-1990s, four big banks and their credit companies dominated the residential mortgage market. To remedy this lack of competition, the government gave SBAB (its company for residential mortgage loans) a new mission after the 1990s crisis. Its mission changed from distributing government mortgage loans to contributing to competition in the residential mortgage market, while maintaining profitability at a reasonable and sustainable level.[40]

One of the largest costs of entering the banking market was establishing a network of offices. One way of getting around this was to merge with or buy existing banks. For example, den Danske Bank bought Östgöta Enskilda Bank, paying 90 percent above par value.[41]

After the bank mergers, during the 1990s crisis, there were few mid-sized banks left; one way for them to reach customers was through cooperation with other actors. During 1996, cooperation began between SBAB and Östgöta Enskilda Bank (before it merged with den Danske Bank), and between SBAB and GE (General Electric) Capital.[42]

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[39] Bergman, "Konkurrensen på bankmarknaden."

[40] For example, see SBAB Annual Report 2003, p. 3; "Det uthålliga oligopolet" [The Sustained Oligopoly], *Affärsvärlden* [Business World] (19 June 2002). URL: http://www.affarsvarlden.se.

[41] RBFS [Riksbankens Code of Statutes] 2003:2.

[42] SBAB Annual Report 1996, p. 11.

At the same time these banks merged, the new regulations affected the market, and thirteen so-called niche banks, which were smaller joint-stock companies, were started by other than the already established banks. Insurance companies started Skandia-banken and Länsförsäkringar Bank. IKEA (Ingvar Kamprad Elmtaryd Agunnaryd) established Ikano-banken, its investment in the bank market, in 1999.[43] In addition to offering credits at IKEA stores, Ikano-banken could now offer residential mortgage loans. Even ICA, which was one of Sweden's biggest retail chains, invested in establishing a bank in 2001. ICA, with its 2,000 department stores, had a new way to distribute mortgage loans.[44] Both Ikano-banken and ICA-banken cooperated with SBAB; consequently, SBAB could reach customers through these new "offices," and their partners could increase their banking services with mortgage loans (see Figure 2). The cooperation agreement was that the partner got provision for the mortgage loan they sold.[45] The interest rates were similar, so although there were fewer competitors with this system, the SBAS was stronger compared to the larger banks and their credit companies.

In addition to the changes in the structure of the actors in the residential mortgage market, financing also changed after deregulation. In the early 1980s, institutions introduced financial instruments such as certificates, treasury bills, and market warrants, which often matured in less than one year.[46] Moreover, the financial instruments continued to develop, and their securitization was one of the most important innovations in the residential mortgage market. Securitization meant that many mortgage loans were bundled together in companies specially formed for that purpose, so-called Special Purpose Vehicles (SPVs). The companies issued bonds with the mortgage loans as security. Bonds had ratings, and before the subprime crisis, the raters considered houses to be very secure; thus, the ratings were the highest possible: AAA. With AAA ratings, a lender's classification was higher than it was for its normal borrowing transactions. The borrowing costs were slightly higher than the mortgage company's traditional costs, but the lifting of the loans from the balance sheet compensated for this fact. Thus, the banks realized more capital and the circulation rapidly increased.[47] In turn, banks needed less capital to cover the regulated capital adequacy requirement.

In contrast to the period between 1950 and 1985, before deregulation, major changes characterized the period between 1985 and 2005. During

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[43] SBAB Annual Report 1998, p. 1; 1999, p. 3.

[44] ICA Press Release: "ICA Banken och SBAB i samarbete om bolån" [The Bank of ICA and SBAB in Residential Mortgage Loan Cooperation] (18 Dec. 2001).

[45] SBAB Interim Report Q3, 2005.

[46] Johan A. Lybeck and Gustaf Hagerud, *Penningmarknadens instrument* [Money Market Instruments] (Stockholm, 1991).

[47] A. Haskel, "Värdepapperisering" [Securitization], *Affärsdata* [Business Data] (5 Feb. 1998). URL: http://www.ad.se/.

the earlier period, the actors were stable and filled particular segments in the residential mortgage market. After deregulation, many actors disappeared, while some new ones entered the market. Most that disappeared were mid-sized banks, while the new entries were small-sized niche banks (with one exception, SBAB). The actors had competed under similar conditions; now they could choose whether or not they wanted a third party involved (see Figure 2). For example, the insurance companies were no longer restricted to a passive role in financing and, if they wished, could be active as lenders. Hence, the actors' function in the residential mortgage market became more complex. Another difference was the number of foreign investors. For example, about two-thirds of the securitizations SBAB issued were international.[48]

Government functions in the residential mortgage market changed. Earlier, the government was active as a large lender and financier of government mortgage loans. During the second period, the government was a joint owner of Nordea and wholly owned SBAB, but its function was passive.

Conclusions

After World War II, an important tenet of the Swedish welfare state was that a modern society should provide good dwellings for everyone. The demand for houses increased due to the growing population and greater urbanization. To meet this demand, it was most important to have a healthy credit system with low interest rates, but low interest rates threatened to increase the demand for credit. Consequently, there was a need to control the credit market to limit loans and to direct existing credit to prioritized areas such as the residential mortgage market.

These regulations survived until the mid-1980s, when there were calls, both globally and nationally, for the economy to conform to the market to increase its efficiency. Furthermore, the amount of credit increased despite the regulations because of the development of creative ways to bypass the system, and a grey market for credit developed. This was a time of deregulation, not only for the financial market as a whole, but also for the residential mortgage market for freestanding and semi-detached homes.

My main purpose in this essay was to study whether or not a regulatory regime change occurred in the Swedish residential mortgage market, with "regime change" defined according to David Llewellyn's theories. The key components in a regulatory regime were: the rules established by regulatory agencies; monitoring and supervision by official agencies; enhancing the discipline of the market; intervening in the case of bank failure; the role of internal corporate governance arrangements

[48] SBAB Annual Report 2005.

within the financial institutions; and the motivating structure for government, borrower, and lender.[49]

The rules changed in the 1980s, and the most significant changes were the abolishment of regulations. The currency and interest-rate controls and the ceiling for lending vanished. Some of these changes came from so-called informal institutions; for example, lenders found ways around the regulated financial system, rendering the lending ceiling less effective.

Monitoring and supervision by official agencies also changed with deregulation. Many more actors could enter the market when the rules for bank charters eased and compound trading was allowed; hence, there was an increase in competition. However, this also meant less precise regulations. With increasingly differentiated actors in broader economic areas, the regulations needed to cover a bigger area. This was in contrast to the earlier period, when the regulations for different actors were tailored to the specific actor.

Furthermore, the incentives to follow the rules had come strictly from the government; this changed to enhancing the discipline of the market, to allow the market find its own way to provide incentives for following the rules. With this came the development of much greater emphasis on self-control of the market.

The regulatory regime, according to Llewellyn, should also be able to intervene in the case of bank failure. During the period before deregulation, this was never tested, but the government had to intervene as a lender of last resort several times during the crisis of 1992. One of the reasons the government did not need to rescue banks and other institutions in the residential mortgage market during the earlier period was that they were strongly protected by regulations. In addition to the minimal competition, the government interest-rate guarantee partly protected the loans.

The role of internal corporate governance arrangements within financial institutions changed, too, between the first and the second periods. For example, during the earlier period, the strict regulations made it hard to increase profits by increasing risk-taking; after deregulation, that was definitely possible. The regulatory regime lost its role in strong internal corporate governance and, as a result, some of its role in disciplining and demanding responsibility of the different actors within the regime.

Finally, the motivating structure for government, borrower, and lender changed. It went from strictly government-controlled to market-controlled, from a basis in Keynes's economic theories to neo-classical theories, from rigidly regulated to deregulated. This motivating structure changed not only in Sweden, but also globally, which affected Sweden's actions.

[49] Llewellyn, "A Regulatory Regime for Financial Stability."

The regulatory regime change that occurred affected the actors in this market. The primary differences were in who was allowed to lend, how much they were allowed to lend, and how the loans were financed. Furthermore, the structure of the actors changed. During the first period, when the government worked as the only strong actor in this market, there were a few big and many medium-sized lenders. During the second period, there were still a few big actors, but the medium-sized group had disappeared, replaced by many new, small-sized actors. The government disappeared as an active actor; many of the big actors from the earlier period remained and became even bigger by merging with the medium-sized actors. The new big actor was SBAB, owned by the government, although the government had a very passive role. The small-sized banks were the so-called niche banks, often with origins in other larger organizations, such as insurance companies and corporate groups in retail business.

Thus, using David T. Llewellyn's criteria, we conclude that the regulatory regime of the Swedish residential mortgage market clearly changed, and that the purpose of those changes was to move the regulatory regime from a more- to a less-regulated system. Our next step is to investigate how those changes and the difference in regimes have affected risk exposure in the residential mortgage market.