



Questions and answers

on the ESRB Warnings on medium-term vulnerabilities in the residential real estate sectors of eight Member States

1. What is an ESRB warning?

The ESRB has a legal mandate to issue warnings and/or recommendations when significant systemic risks are identified. A warning is issued in order to raise awareness or draw attention to a systemic risk. A recommendation is a more far-reaching policy tool, which also specifies recommended remedial action. The ESRB decides, on a case-by-case basis, whether a warning or a recommendation should be made public, bearing in mind that disclosure can help to foster compliance. The ESRB then monitors if, and to what extent, the systemic risk is addressed.

2. What are the present ESRB warnings about?

The ESRB has issued warnings to eight EU Member States about medium-term vulnerabilities relating to residential real estate. This follows a recent forward-looking, Union-wide assessment that the ESRB conducted of risks from residential real estate. In general, the assessment identified vulnerabilities related to the ability of households in these countries to repay their mortgage debt or maintain their consumption under different economic scenarios and/or to developments in the residential real estate market itself (for example, a loosening in lending conditions, rapid price growth or overvaluation). The ESRB performed an analysis of risks to the banking system from residential real estate. At this time, the ESRB has not identified direct near-term risks arising from residential real estate exposures in the banking systems of the warned countries, although second-round effects are not excluded in the medium term. Moreover, EU Member States have taken steps to strengthen the resilience of their banking sectors, for example through the increase in bank capital requirements in recent years. In most of the warned countries, however, medium-term vulnerabilities are generated by a combination of household indebtedness and price dynamics. The specific vulnerabilities vary in the individual Member States and further details can be found within the warnings and the supporting vulnerability assessments.

3. Which Member States have been sent a warning?

The ESRB concluded that it was necessary from a macroprudential perspective to issue warnings to eight EU Member States in which it was assessed that significant vulnerabilities prevail. These eight countries are: Austria, Belgium, Denmark, Finland, Luxembourg, the Netherlands, Sweden and the United Kingdom.

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4. What are the main vulnerabilities that have been identified?

The specific nature of the vulnerabilities that have been identified varies across the eight Member States that have received an ESRB warning. However, they are generally related to the capacity of borrowers to repay their mortgage debt and developments in property markets.

Vulnerabilities related to borrowers generally concern the level of indebtedness or the terms of mortgages (for example, whether the costs incurred by households when servicing their mortgage debt are highly sensitive to changes in interest rates). In the event of an economic or financial shock – such as an increase in unemployment – highly indebted households may find it particularly difficult to service their debts and may respond by reducing their consumption and potentially defaulting on their mortgage debt. Vulnerabilities related to property markets are generally related to the sustainability of residential real estate prices. Changes in real estate price dynamics have macro-financial implications: any sudden decrease in real estate prices will affect lenders' collateral and households' wealth, and any rapid increase can put pressure on households to borrow more to purchase residential real estate. The vulnerabilities are of a medium-term nature; with respect to the banking systems in these Member States, no direct near-term vulnerabilities relating to banks' direct exposures were identified. Member States have taken steps to strengthen the resilience of their banking systems to a range of adverse shocks.

Full details of the ESRB's analysis are included in the [ESRB report Vulnerabilities in the EU residential real estate sector](#).

5. Are the vulnerabilities cyclical or structural in nature?

In most cases both cyclical and structural vulnerabilities were identified in the eight Member States that have received the ESRB warnings. However, the specific nature of the identified vulnerabilities and their drivers vary across the eight Member States. In some cases, it is mainly structural and institutional factors that are influencing the nature of vulnerabilities. Examples include tax advantages to owning residential real estate instead of renting, lack of a developed rental market, and demographic factors that lead to high demand for city living despite the limited supply of property. In other cases, vulnerabilities are driven by cyclical factors that are increasing demand for residential real estate – for example, in countries which are recovering from earlier recessions or housing market downturns.

6. How did the ESRB conduct the vulnerability assessment?

The warnings were issued following a forward-looking Union-wide assessment of vulnerabilities relating to residential real estate. The ESRB – in collaboration with the European Central Bank (ECB) – performed a cross-country analysis of risk indicators for all Member States in the Union. This was used to identify a set of focus countries for country-specific analysis. Subsequently there was an in-depth analysis of the focus

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countries, taking account of country-specific factors relating to structural and institutional features and policy measures. Building on previous work by the ESRB, vulnerabilities were identified and separated into three “stretches” – collateral, household and banking – where the collateral stretch captures the price levels and dynamics in residential real estate markets; the household stretch captures the implications of household borrowers’ debt for their consumption and behaviour; and the banking stretch captures the potential impact on lenders of developments in residential real estate. The ESRB performed a broad system-wide analysis of risks to the banking system from residential real estate, rather than a stress-test or institution-specific analysis. Identified vulnerabilities were compared with structural features of the country and national policy measures (macroprudential and broader economic policies) to assess if the vulnerabilities were either mitigated or amplified by these factors. With respect to Member States where vulnerabilities were expected to prevail in the medium term, the ESRB has issued warnings. For the United Kingdom, the ESRB has not assessed whether policies in place are appropriate and sufficient given the uncertain impact of the vote to leave the European Union on the medium-term outlook for the UK housing market.

7. Do the warnings reflect the latest developments in residential real estate markets?

The ESRB analysis took account of developments and available data up to mid-September 2016.

8. Why are the risks deemed to be medium-term?

The ESRB analysis is forward-looking, with the aim of identifying vulnerabilities that are a source of systemic risk to financial stability in time for measures to be taken to mitigate the risks or the impact should they materialise. Household indebtedness and the overvaluation of residential real estate develop over the course of years; it usually takes time before they build up to critical levels but, in the event of a shock, the related vulnerabilities can materialise quickly – for example, in the form of reduced household consumption, loan defaults and price falls. The ESRB took account of the vulnerabilities and trends that have the potential to disrupt financial stability over a period of around five years. Even though the identified vulnerabilities are generally not expected to materialise in the short run, it does not mean that policy measures should not be taken promptly: macroprudential and other economic policy measures are more effective when introduced in a timely manner.

9. Did the ESRB analyse residential real estate sector-related vulnerabilities in all the Union’s Member States?

The ESRB – in collaboration with the ECB – performed a cross-country analysis of risk indicators for all Member States in the Union. This was used to identify a set of focus countries for further analysis, which took into account country-specific factors relating to structural and institutional features and policy measures.

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The ESRB identified 11 Member States for country-specific analysis: Austria, Belgium, Denmark, Estonia, Finland, Luxembourg, Malta, the Netherlands, Slovakia, Sweden and the United Kingdom. Following the country analysis, the ESRB concluded that from a macroprudential perspective significant vulnerabilities prevail in the eight Member States to which warnings were issued. Following the in-depth country-specific analysis of Malta, it was concluded that there are no significant sources of medium-term risks to financial stability from residential real estate in that Member State. While vulnerabilities were identified for Estonia and Slovakia, these are expected to be mitigated by policy measures or institutional factors in the medium term and so warnings were not issued to those Member States. For the United Kingdom, the ESRB has not assessed whether policies in place are appropriate and sufficient given the uncertain impact of the vote to leave the EU on the medium-term outlook for the UK housing market. The analysis took account of data and developments up to mid-September 2016.

Full details of the ESRB's analysis are included in the [ESRB report Vulnerabilities in the EU residential real estate sector](#).

10. Are vulnerabilities in the residential real estate sector a Union-wide problem?

Following a Union-wide risk assessment, significant vulnerabilities have been identified as prevailing in the residential real estate sectors of only 8 out of the 28 Member States. These eight Member States are: Austria, Belgium, Denmark, Finland, Luxembourg, the Netherlands, Sweden and the United Kingdom. This means that there is not a Union-wide issue. In its analysis, the ESRB took account of the fact that vulnerabilities in these Member States could potentially spill over to other Member States – for example in regions where the national financial systems are closely interlinked, such as the Nordic-Baltic region. While vulnerabilities were also identified for Estonia and Slovakia, these are expected to be mitigated by policy measures that have been taken or prevailing institutional factors in the medium term and so warnings were not issued to these countries.

Full details of the ESRB's analysis are included in the [ESRB report Vulnerabilities in the EU residential real estate sector](#).

11. Why are vulnerabilities in the residential real estate sector a macroprudential issue?

The role of macroprudential monitoring and policy is to identify and respond to sources of systemic risks to financial stability. Developments in the residential real estate sector can have significant implications for financial stability and the real economy. Residential real estate represents a major part of households' wealth, and mortgage debt is the largest and most common form of debt among households in the European Union. From the perspective of the financial system, mortgages often make up large parts of banks' balance sheets and residential real estate constitutes a major source of collateral for lenders. Past

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experience in many countries shows that the manifestation of residential real estate vulnerabilities – such as exuberant developments in lending conditions or markets – can lead to significant risks to domestic financial stability and serious negative consequences for the real economy, as well as to negative spillovers to other countries. In particular, should there be a re-pricing of risk, such vulnerabilities could lead to negative feedback loops between falling house prices, reduced household spending, bank losses and credit contraction.

12. What should the warned Member States do next?

Unlike in the case of an ESRB recommendation, an ESRB warning does not recommend specific remedial action in response to the risks identified. It is for the individual Member States to decide how to respond to the warning, and what actions to take in response to the identified vulnerabilities.

The eight warnings on residential real estate were addressed to the relevant ministers in each Member State; the head of the national macroprudential authority also received a copy of the warning. The addressees were chosen with consideration that the potential policy response may extend beyond the mandate of macroprudential authorities. Addressees have the opportunity to respond to the warning, and the response will be made available on the [warnings page of the ESRB website](#).

13. What will the ESRB do next?

The ESRB will continue exercising its mandate of macroprudential oversight of the financial system in the European Union, including identifying financial stability vulnerabilities related to residential real estate. The ESRB will continue to issue warnings if a significant systemic risk to financial stability is identified and, where appropriate, issue recommendations for remedial action.

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