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(Resolutions, recommendations and opinions)

RECOMMENDATIONS

EUROPEAN SYSTEMIC RISK BOARD

RECOMMENDATION OF THE EUROPEAN SYSTEMIC RISK BOARD

of 2 December 2021

on medium-term vulnerabilities in the residential real estate sector in Germany

(ESRB/2021/10)

(2022/C 122/01)

THE GENERAL BOARD OF THE EUROPEAN SYSTEMIC RISK BOARD,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board ([1]), and in particular Article 3(2)(b) and (d) and Articles 16 and 18 thereof,

Having regard to Decision ESRB/2011/1 of the European Systemic Risk Board of 20 January 2011 adopting the Rules of Procedure of the European Systemic Risk Board ([2]), and in particular Article 18 thereof,

Whereas:

(1) The real estate sector plays an important role in the economy and its developments may have a material influence on the financial system. Past financial crises have demonstrated that unsustainable developments in real estate markets may have severe repercussions on the stability of the financial system and of the economy as a whole, which may also lead to negative cross-border spillovers. Adverse real estate market developments in some Member States have, in the past, resulted in large credit losses and/or had a negative impact on the real economy. Such effects reflect the close interplay between the real estate sector, funding providers and other economic sectors. Furthermore, the feedback loops between the financial system and the real economy may reinforce any negative developments.

(2) These links are important because they mean that risks originating in the real estate sector may have a systemic impact. Financial system vulnerabilities tend to accumulate during the upswing phase of the real estate cycle. The perceived lower risks of, and easier access to, funding may contribute to a rapid expansion of credit and investment, together with an increased demand for real estate, which puts upward pressure on property prices. Furthermore, feedback loops between house prices and credit may result in potential systemic consequences. Conversely, during the downturn phase of the real estate cycle, tighter credit conditions, higher risk aversion and downward pressure on real estate prices may adversely affect the resilience of borrowers and lenders, thereby weakening economic conditions.

([1]) OJ L 331, 15.12.2010, p. 1.
([2]) OJ C 58, 24.2.2011, p. 4.

(3) Vulnerabilities relating to residential real estate (RRE) can be a source of systemic risk and they may affect financial stability both directly and indirectly. Direct effects are credit losses on mortgage portfolios due to adverse economic or financial conditions and simultaneous negative developments in the RRE market. Indirect effects could be related to adjustments in household consumption or deleveraging by lenders, leading to further consequences for the real economy and financial stability.

(4) As noted in recital 4 of Recommendation ESRB/2013/1 of the European Systemic Risk Board ([3]), the ultimate objective of macroprudential policy is to contribute to safeguarding the stability of the financial system as a whole, including by strengthening the resilience of the financial system and decreasing the build-up of systemic risks, thereby ensuring a sustainable contribution of the financial sector to economic growth.

(5) To this end, macroprudential authorities may use one or more of the capital-based macroprudential measures set out in Directive 2013/36/EU of the European Parliament and of the Council ([4]) and Regulation (EU) No 575/2013 of the European Parliament and of the Council ([5]), and/or borrower-based macroprudential measures, which are exclusively based on national law, depending on the assessment of risks. While the capital-based measures are primarily aimed at increasing the resilience of the financial system, the borrower-based measures may be particularly suitable for preventing the further build-up of systemic risks in relation to new housing loans.

(6) In 2019, the European Systemic Risk Board (ESRB) conducted a systematic and forward-looking European Economic Area (EEA)-wide assessment of vulnerabilities relating to RRE ([6]). This assessment enabled the ESRB to identify a number of medium-term vulnerabilities in several countries as sources of systemic risk to financial stability, which led to the issuance of warnings to five countries, including Germany ([7]).

(7) In 2019, the main vulnerabilities identified in the RRE market in Germany were the significant overvaluation of house prices in urban areas, associated with widespread and rapid house price dynamics and some indication of a loosening of lending standards for housing loans, albeit in the context of the overall uncertainty due to significant data gaps.

(8) The ESRB has recently concluded a further systematic and forward-looking EEA-wide assessment of vulnerabilities relating to RRE. The results of this assessment show that after receiving country-specific warnings in September 2019, some of the countries have taken further action to remedy the related vulnerabilities. In particular, Czech Republic adopted a legal framework for borrower-based measures, Germany established a legal basis for collection of data on lending standards of new housing loans to households, France activated limits on debt service-to-income (DSTI) ratios, Iceland tightened the limits on loan-to-value (LTV) ratios, and Norway tightened the rate of its systemic risk buffer. However, given the increasing vulnerabilities, the actions adopted by some of the countries were not considered sufficient according to the ESRB assessment.

(9) The outbreak of the COVID-19 pandemic in 2020 and the related crisis have not led to a cyclical decline in housing markets. Rather, following a period of gradual growth, and amidst the low interest rate environment, real house price and lending growth have accelerated further in several countries, largely outpacing the growth in household income. In order to mitigate the impact of the pandemic and the resulting economic uncertainty, various measures and policies, such as moratoria and public guarantees, have been implemented. In this broad policy context, previously scheduled macroprudential measures have been temporarily relaxed or their activation delayed in some countries. The currently observed improvement in the economic situation allows for an adjustment of macroprudential policy in those countries in which RRE related vulnerabilities have continued to build up.

([3]) Recommendation ESRB/2013/1 of the European Systemic Risk Board of 4 April 2013 on intermediate objectives and instruments of macro-prudential policy (OJ C 170, 15.6.2013, p. 1).

([4]) Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

([5]) Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

([6]) See Vulnerabilities in the residential real estate sectors of the EEA countries, ESRB, September 2019, available on the ESRB website at www.esrb.europa.eu.

([7]) Warning ESRB/2019/11 of the European Systemic Risk Board of 27 June 2019 on medium-term vulnerabilities in the residential real estate sector in Germany (OJ C 366, 30.10.2019, p. 45).

(10) As regards Germany, this recent assessment has revealed that, despite the establishment of a legal framework for borrower-based instruments in 2017, consisting of a limited set of measures (an LTV ratio cap and an amortisation requirement), none of them were activated in order to address the accumulation of medium-term vulnerabilities in the RRE sector. The ESRB takes note of the fact that, under the current legal framework, requirements were not met for the activation of existing borrower-based measures.

(11) The ESRB's assessment also shows that rises in house prices have become more broad-based across both urban and rural areas. As a result, existing estimates point to high and increasing overvaluation of house prices in Germany. Comprehensive analysis of vulnerabilities is currently hindered by the lack of detailed data on lending standards for housing loans, albeit that action has been taken to collect data from 2023 due to the entry into force in 2021 of the national regulation on data collection regarding housing loans. For the recent period, the available information provides mixed evidence about the evolution of lending standards for housing loans. While the results of the euro area bank lending survey (BLS) suggest that credit conditions for house purchase tightened further over the course of 2020, an alternative private sector data source ([8]) indicates that the share of loan applications with high LTV ratios further increased in 2020. Another alternative private sector data source available to the German authorities, containing actual transactions and representing a part of the aggregate market, confirms that LTV ratios have increased over the last decade somewhat. Furthermore, consistent with the BLS, LTV ratios have receded in the wake of the crisis. The data also reveal that DSTI ratios and maturities declined in the first half of the 2010s and increased again in the second half. On the other hand, debt-to-income (DTI) ratios have increased steadily since 2009.

(12) In addition, after relaxing its countercyclical capital buffer (CCyB) rate in response to the COVID-19 crisis, Germany did not make further use of capital-based measures to address existing vulnerabilities stemming from the RRE sector and foster financial stability.

(13) In the light of these recent developments, in particular given the evidence of overvaluation of house prices, the ESRB has concluded that borrower-based measures should be activated to target medium-term vulnerabilities in the RRE sector in Germany. Therefore, the German authorities should promptly activate a legally binding or, if that is not possible under German law, a non-legally binding limit on the LTV ratio, to ensure sound lending standards against the overvaluation of house prices. At the same time, and to complement the LTV ratio measure, capital-based measures, such as activating the CCyB or the sectoral systemic risk buffer (SSyRB), would increase the resilience of the banking sector in Germany against the RRE vulnerabilities that might have already accumulated, given the prevailing overvaluation of house prices and uncertainty about lending standards for mortgage loans provided in recent years. Moreover, an appropriate combination with legally binding or, if that is not possible under German law, non-legally binding income-related instruments could increase the effectiveness of the limit on the LTV ratio in addressing any vulnerabilities relating to the financing of RRE. Therefore, the German legal framework for borrower-based measures should be complemented by income-based instruments and adapted accordingly so as to allow the activation of borrower-based measures in a more timely manner, thus avoiding the build-up of vulnerabilities,

HAS ADOPTED THIS RECOMMENDATION:

SECTION 1

RECOMMENDATIONS

Recommendation A – Limit on the LTV ratio

It is recommended that the relevant authorities impose a legally binding limit that applies to the LTV ratio in order to mitigate vulnerabilities in the residential real estate sector in Germany as a source of risk to financial stability, which may have the potential for serious negative consequences for the real economy. Where this is not possible under German law, it is recommended that the relevant authorities activate a non-legally binding limit that applies to the LTV ratio to address the objectives set out therein.

([8]) Information provided by a loan brokerage platform which may, however, not be fully representative of the German mortgage market.

Recommendation B – Activation of capital-based measures

It is recommended that the relevant authorities activate appropriate capital-based measures, in order to ensure the resilience of credit institutions authorised in Germany and to complement the limit that applies to the LTV ratio as referred to in Recommendation A in mitigating vulnerabilities in the residential real estate sector in Germany as a source of risk to financial stability.

Recommendation C – Legal framework for borrower-based measures with regard to the residential real estate sector

It is recommended that the relevant authorities ensure that the existing legal framework for borrower-based measures includes at least the following legally binding borrower-based measures:

(a) limits that apply to the DTI ratio and limits that apply to the DSTI ratio;

(b) limits that apply to the LTV ratio;

(c) limits that apply to the maturity; and

(d) amortisation requirements.

Recommendation D – Monitoring of vulnerabilities and activation of income-related borrower-based measures

1. It is recommended that the relevant authorities closely monitor vulnerabilities related to household indebtedness, overvaluation of house prices and lending standards for new mortgage loans over the medium term.

2. It is recommended that, according to the results of the monitoring carried out pursuant to sub-Recommendation D(1) and in order to prevent the excessive accumulation of credit risk, relevant authorities activate legally binding income-related borrower-based measures, such as limits on the DTI ratio or on the DSTI ratio. Where this is not possible under German law, it is recommended that the relevant authorities activate non-legally binding income-related borrower-based measures to address the objectives set out therein.

SECTION 2

IMPLEMENTATION

1. **Definitions**

1. For the purposes of this Recommendation the following definitions apply:

   (a) 'relevant authorities' means the authorities entrusted with the amendment of the legal framework for borrower-based measures, the activation of borrower-based measures, the monitoring of systemic risks or the activation of capital-based measures in Germany;

   (b) 'loan-to-value ratio' (LTV ratio) means the sum of all loans or loan tranches secured by the borrower on the immovable property at the moment of loan origination relative to the value of the property at the moment of the loan origination;

   (c) 'capital-based measures' means any own funds requirements imposed on a credit institution to prevent and/or mitigate systemic risk as defined in Article 2(c) of Regulation (EU) No 1092/2010, including, under Articles 124, 164 or 458 of Regulation (EU) No 575/2013 or Chapter 4 of Title VII of Directive (EU) 2013/36, such as the countercyclical capital buffer or the sectoral systemic risk buffer;

   (d) 'credit institution' means a credit institution as defined in point (1) of Article 4(1) of Regulation (EU) No 575/2013;

   (e) 'borrower-based measures' means macroprudential measures that target borrowers, including limits on the LTV ratio, the DTI ratio, the DSTI ratio, maturity, and amortisation requirements;

   (f) 'debt-to-income ratio' (DTI ratio) means the total debt of the borrower at the moment of loan origination relative to the borrower's total annual disposable income at the moment of loan origination;

(g) ‘debt service-to-income ratio’ (DSTI ratio) means the annual total debt service relative to the borrower’s total annual disposable income at the moment of loan origination;

(h) ‘debt service’ means the combined interest and principal repayment on a borrower’s total debt over a given period;

(i) ‘maturity’ means the duration of the residential real estate loan contract expressed in years at the moment of loan origination;

(j) ‘amortisation requirements’ means measures related to the repayment schedule of the loan.

2. Criteria for implementation

1. The following criteria apply to the implementation of this Recommendation:

   (a) due regard should be given to the principle of proportionality, taking into account the objective and content of Recommendation A, Recommendation B, Recommendation C and Recommendation D;

   (b) when activating borrower-based measures or capital-based measures under Recommendation A, Recommendation B and Recommendation D, their calibration and phasing-in should take into account the position of Germany in the economic and financial cycles, and any potential implications as regards the associated costs and benefits;

   (c) specific criteria for compliance with this Recommendation are set out in the Annex.

2. Addressees are requested to report to the European Parliament, the Council, the Commission and to the ESRB on the actions undertaken in response to this Recommendation, or adequately justify any inaction. The reports should as a minimum contain:

   (a) information on the substance and timeline of the actions undertaken;

   (b) an assessment of the vulnerabilities related to household indebtedness and lending standards for new mortgage loans, including the distribution of new mortgage loans according to their LTV, DTI and DSTI ratios, maturities, and amortisation profile with the relevant ratios being calculated in accordance with Annex IV to Recommendation ESRB/2016/14 of the European Systemic Risk Board [9], together with the functioning of the actions undertaken, having regard to the objectives of this Recommendation;

   (c) a detailed justification of any inaction or departure from this Recommendation, including any delays.

3. Timeline for the follow-up

In accordance with Article 17(1) of Regulation (EU) No 1092/2010, the addressees must communicate to the European Parliament, the Council, the Commission and to the ESRB the actions undertaken in response to this Recommendation or substantiate any inaction. The addressees are requested to submit such communication in compliance with the following timelines:

1. *Recommendation A*

   By 30 June 2023 and by 30 June 2025, the addressees of Recommendation A are requested to submit to the European Parliament, the Council, the Commission and to the ESRB a report on any actions taken with regard to imposing a limit that applies to the LTV ratio in order to mitigate the vulnerabilities in the residential real estate sector in Germany as a source of risk to financial stability. Where there is more than one authority responsible for taking actions to address the vulnerabilities identified, one joint report should be submitted.

2. *Recommendation B*

   By 30 June 2023 and by 30 June 2025, the addressees of Recommendation B are requested to submit to the European Parliament, the Council, the Commission and to the ESRB a report on any actions taken with regard to implementing capital-based measures. Where there is more than one authority responsible for taking actions to address the vulnerabilities identified, one joint report should be submitted.

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[9] Recommendation ESRB/2016/14 of the European Systemic Risk Board of 31 October 2016 on closing real estate data gaps (OJ C 31, 31.1.2017, p. 1).

3. *Recommendation C*

   By 30 June 2025, the addressees of Recommendation C are requested to submit to the European Parliament, the Council, the Commission and to the ESRB a final report on the implementation of Recommendation C, including a statement clarifying which authority or authorities is responsible for the decision to activate and implement the borrower-based measures set out in that Recommendation. Where there is more than one authority responsible for taking actions to address the vulnerabilities identified, one joint report should be submitted.

4. *Recommendation D*

   By 30 June 2023 and by 30 June 2025, the addressees of Recommendation D are requested to submit to the European Parliament, the Council, the Commission and to the ESRB a report on monitoring vulnerabilities related to household indebtedness, overvaluation of house prices and lending standards for new mortgage loans over the medium term, and actions taken to address such vulnerabilities. Where there is more than one authority responsible for taking actions to address the vulnerabilities identified, one joint report should be submitted.

4. **Monitoring and assessment**

1. The ESRB Secretariat will:

   (a) assist the addressees, ensuring the coordination of reporting and the provision of relevant templates, and detailing where necessary the procedure and the timeline for the follow-up;

   (b) verify the follow-up by the addressees, provide assistance at their request, and submit follow-up reports to the General Board.

2. The General Board will assess the actions and justifications communicated by the addressees and, where appropriate, may decide that this Recommendation has not been followed and that an addressee has failed to provide adequate justification for its inaction.

Done at Frankfurt am Main, 2 December 2021.

The Head of the ESRB Secretariat,
on behalf of the General Board of the ESRB
Francesco MAZZAFERRO

ANNEX

SPECIFICATION OF COMPLIANCE CRITERIA APPLICABLE TO THE RECOMMENDATION

Recommendation A – Limit on the LTV ratio

The following compliance criteria are applicable to Recommendation A.

1. When activating a limit that applies to the loan-to-value (LTV) ratio, the addressees should seek to prevent a significant or an increasing share of new mortgage loans secured by residential real estate (RRE), that could result in credit losses in the event of their default combined with a decrease in house prices, following adverse economic or financial conditions, an increase in the cost of servicing their debt or adverse developments in the RRE market.

2. The addressees should use one or several borrower-based measures to ensure the effectiveness of the measures in place and to minimise any potential for their circumvention or for unintended consequences that could reduce their effectiveness and possibly create risks in other areas, in particular by ensuring that the measures are applicable to loans granted by all types of lenders, to natural persons as borrowers and – to the degree deemed necessary – to all other types of borrowers.

3. Prior to activating a limit that applies to the LTV ratio, an assessment should be made of Germany's position in the economic and financial cycles, in order to determine the appropriate calibration and phasing-in of such measures.

4. After the activation of a limit that applies to the LTV ratio, its further tightening or the activation of additional borrower-based measures may be needed to address the vulnerabilities identified in Germany. This will depend on the choice of the measures activated, on the initial calibration of those activated measures and on the results of the assessment of vulnerabilities.

5. When activating or calibrating a limit that applies to the LTV ratio, the addressees should take into account all loans which are to be ultimately serviced by households from their income, regardless of the form of the loans.

Recommendation B – Activation of capital-based measures

The following compliance criteria are applicable to Recommendation B.

1. When activating capital-based measures, the addressees should seek to ensure the resilience of credit institutions authorised in Germany in the face of the potential materialisation of systemic risk related to RRE which could lead to direct and indirect credit losses stemming from mortgage loans or arising as a consequence of the decrease in consumption by households with housing loans.

2. Prior to activating capital-based measures, an assessment should be made of Germany's position in the economic and financial cycles in order to determine whether activating such measures would be appropriate.

3. After the activation of the capital-based measures, their further tightening or the activation of additional macroprudential measures may be needed to address the vulnerabilities identified in Germany. This will depend on the choice of the capital-based measures activated, on the initial calibration of those activated measures and on the results of the assessment of vulnerabilities.

Recommendation C – Legal framework for borrower-based measures with regard to the residential real estate sector

The following compliance criteria are applicable to Recommendation C.

1. The German legal framework for borrower-based measures should ensure that:

   (a) the limits that apply to the debt-to-income (DTI) ratio and to the debt service-to-income (DSTI) ratio, as well as maturity limits, are applicable to loans granted to all types of borrowers and by all types of lenders, in order to avoid any circumvention of the limits, whereby these limits should be applied primarily to natural persons as borrowers, but also to all other types of borrowers if the financing structures imply such an extension in order to avoid circumvention of the limits;

(b) German authorities entrusted with the activation of borrower-based measures are able to activate all legally binding borrower-based measures in an effective and pre-emptive way and are provided with the necessary flexibility in order to design those measures based on the vulnerabilities identified.

2. The amendments to the German legal framework for borrower-based measures should be in force by no later than 1 June 2024.

Recommendation D – Monitoring of vulnerabilities and activation of income-related borrower-based measures

The following compliance criteria are applicable to sub-recommendation D(1).

When monitoring vulnerabilities related to household indebtedness, overvaluation of house prices and lending standards for new mortgage loans over the medium term, the addressees should monitor the share of borrowers taking out new mortgage loans that they are at risk of not being able to repay or service their debt regularly without significantly reducing their consumption following adverse economic or financial conditions, an increase in the cost of servicing their debt or adverse developments in the RRE market.

The following compliance criteria are applicable to sub-recommendation D(2).

1. When activating income-related borrower-based measures, the addressees should seek to prevent a significant or an increasing share of borrowers taking out new mortgage loans that they are at risk of not being able to repay or service their debt regularly without significantly reducing their consumption following adverse economic or financial conditions, an increase in the cost of servicing their debt or adverse developments in the RRE market.

2. The addressees should use one or several borrower-based measures to ensure the effectiveness of the measures in place and to minimise any potential for their circumvention or for unintended consequences that could reduce their effectiveness and possibly create risks in other areas, in particular by ensuring that the measures are applicable to loans granted by all types of lenders, to natural persons as borrowers and, – to the degree deemed necessary – to all other types of borrowers.

3. Prior to activating income-related borrower-based measures, an assessment should be made of Germany's position in the economic and financial cycles, in order to determine the appropriate calibration and phasing-in of such measures.

4. After the activation of the income-related borrower-based measures, their further tightening or the activation of additional borrower-based measures may be needed to address the vulnerabilities identified in Germany, This will depend on the choice of the measures activated, on the initial calibration of those activated measures and on the results of the assessment of vulnerabilities.

5. When activating or calibrating income-related borrower-based measures, the addressees should take into account all loans which are to be ultimately serviced by households from their income, regardless of the form of the loans.