

RECOMMENDATION OF THE EUROPEAN SYSTEMIC RISK BOARD
of 27 June 2019
on medium-term vulnerabilities in the residential real estate sector in Denmark
(ESRB/2019/5)
(2019/C 366/02)

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 Articles 3, 16, 17 and 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 strong feedback loops between the financial system and the real economy 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 that is procyclical in nature. 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. Since the resulting higher collateral values further favour the demand for, and supply of, credit, these self-reinforcing dynamics 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.
- (3) Vulnerabilities relating to residential real estate 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 residential real estate market. Indirect effects could be related to adjustments in household consumption, leading to further consequences for the real economy and financial stability.
- (4) As stated in recital 4 of Recommendation ESRB/2013/1 ⁽²⁾, the ultimate objective of macroprudential policy is to contribute to the safeguard of 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.

⁽¹⁾ OJ L 331, 15.12.2010, p. 1.

⁽²⁾ 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).

- (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 ⁽³⁾ and Regulation (EU) No 575/2013 of the European Parliament and of the Council ⁽⁴⁾, 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.
- (6) In addition, Recommendation ESRB/2013/1 recommends that Member States establish a legal framework that permits the macroprudential authorities to have direct control or recommendation powers over the macroprudential instruments identified in that Recommendation.
- (7) In 2016, the European Systemic Risk Board (ESRB) conducted a Union-wide assessment of the vulnerabilities relating to residential real estate ⁽⁵⁾. 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 eight countries, of which Denmark was one ⁽⁶⁾.
- (8) In 2016 the main vulnerability identified in the residential real estate market in Denmark related to high household indebtedness. A significant share of mortgagors had variable interest rate debt or debt exceeding the value of their home, making them vulnerable to adverse economic or financial conditions or adverse developments in the residential real estate market. Even though there were no overall signs of overvaluation, house prices had been increasing robustly particularly in major cities, and were close to pre-crisis levels.
- (9) The ESRB has recently concluded a systematic and forward-looking European Economic Area (EEA)-wide assessment of vulnerabilities relating to residential real estate ⁽⁷⁾.
- (10) As regards Denmark, this recent assessment has revealed that, since 2016, even though household indebtedness has decreased, it nevertheless remains at one of the highest levels in the EEA. Moreover, the share of existing mortgage loans with deferred amortisation is significant, which makes households structurally more vulnerable to adverse economic or financial conditions or adverse developments in the residential real estate market. In addition, despite the fact that house price growth has slowed and apartment prices in Copenhagen have reached a plateau in recent years, the previous dynamics have led to pockets of overvaluation in the major cities, in particular in Copenhagen. Against this background, a legally binding minimum down payment requirement, which was set at 5 % in 2015, has provided some (albeit limited) additional collateral in the event of a decrease in house prices.
- (11) In 2018, consumer protection legislation introduced restrictions on the provision of residential mortgage products to mortgagors with a debt-to-income (DTI) ratio (before tax) above 4 and an LTV ratio above 60 %. These restrictions require that: (a) interest rates are fixed for at least 5 years; and (b) deferred amortisation is applicable only if the interest rate on a loan is fixed for at least 30 years. Furthermore, the Supervisory Diamond for mortgage banks was announced in 2014. It comprises a number of benchmarks and limit values set for special risk areas within banking activities, and is aimed at increasing the credit quality of the stock of mortgage loans by 2018 and 2020, thereby affecting the production of new loans. Moreover, in 2018 the countercyclical capital buffer rate was increased twice: from 0 % to 0,5 % from 1 March 2019; and from 0,5 % to 1 % from September 2019. In addition, the Danish Systemic Risk Council has recommended a further increase from 1 % to 1,5 % from June 2020 and has issued forward guidance that it should be increased to its potential maximum of 2,5 % unless there is a significant change in the build-up of risk in the Danish financial system. Finally, *Finanstilsynet* (the Danish Financial Supervisory Authority) has issued a guideline that requires credit institutions to display caution in their credit assessment of households when lending to real estate in geographical areas in which residential real estate prices have been growing.

⁽³⁾ 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 and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

⁽⁴⁾ Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

⁽⁵⁾ See 'Vulnerabilities in the EU Residential Real Estate Sector', ESRB, November 2016, available on the ESRB's website at www.esrb.europa.eu

⁽⁶⁾ Warning ESRB/2016/07 of the European Systemic Risk Board of 22 September 2016 on medium-term vulnerabilities in the residential real estate sector of Denmark (OJ C 31, 31.1.2017, p. 47).

⁽⁷⁾ See 'Vulnerabilities in the residential real estate sectors of EEA countries', ESRB, 2019, available on the ESRB's website at www.esrb.europa.eu

- (12) Despite the number of macroprudential measures in place, and given the high level of household indebtedness and the significant share of mortgagors vulnerable to adverse economic conditions or adverse developments in the residential real estate market, the current capital-based measures may not be sufficient to address the accumulated vulnerabilities. Furthermore, tightening of existing or activation of additional borrower-based measures may be necessary in the medium term if vulnerabilities related to household indebtedness, overvaluation of house prices and lending standards increase.
- (13) While cyclical factors play an important role in fuelling the vulnerabilities identified in Denmark, there are also structural factors that have driven these vulnerabilities, resulting in a higher level of systemic risk. These factors include: (i) complex rental market regulations with caps on rent in a significant share of apartment buildings in the major cities, which creates a lack of housing supply and exerts upward pressure on house prices and debt for households that buy their own property; and (ii) the tax deductibility of mortgages, which may act as an incentive for households to overborrow. Furthermore, since 2001 the system of housing property taxation has been decoupled from market prices, resulting in a decline in the effective tax rate, especially in the major cities. In 2017 the Danish parliament passed into law a bill on a new housing taxation system that re-establishes the link between taxes payable and current residential real estate market prices, which will take effect in 2021.
- (14) Therefore, the ESRB has concluded that while the macroprudential measures that are in place or available in Denmark are appropriate, they are partially sufficient to address the vulnerabilities related to household indebtedness in the medium term. Consequently, further policy action is required to address these vulnerabilities, which can be a source of systemic risk. The measures proposed in this Recommendation are aimed at complementing the existing macroprudential measures in Denmark. Given that the vulnerabilities are, to some extent, driven by structural factors which go beyond macroprudential policy, other policies are needed to complement and support the current macroprudential measures, with the aim of addressing factors contributing to the build-up of systemic risks in the residential real estate market in Denmark more efficiently and effectively, without producing excessive costs for the Danish real economy and financial system.
- (15) The purpose of this Recommendation is to recommend: a) the activation of further, or the tightening of existing, capital-based measures in order to ensure the resilience of the banking sector against the medium-term vulnerabilities identified in Denmark; b) the monitoring of vulnerabilities and the activation of further, or the tightening of existing, borrower-based measures if house price growth and credit growth accelerate in the medium term. This Recommendation also aims to emphasise the need for broader policy action aiming to curb factors which facilitate or promote increasing household indebtedness.
- (16) This Recommendation is without prejudice to the monetary policy mandates of the central banks in the Union.
- (17) ESRB recommendations are published after the General Board has informed the Council of the European Union of its intention to do so and provided the Council with an opportunity to react, and after the addressees have been informed of the intention to publish,

HAS ADOPTED THIS RECOMMENDATION:

SECTION 1

RECOMMENDATIONS

Recommendation A – Activation or tightening of capital-based measures

It is recommended that the macroprudential authority, the designated authority or the competent authority in Denmark, as applicable, ensure, by activating additional or tightening existing capital-based measures, the resilience of credit institutions authorised in Denmark in the face of the potential materialisation of systemic risk related to residential real estate 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.

Recommendation B — Monitoring of vulnerabilities and activation or tightening of borrower-based measures

1. It is recommended that the Danish national authorities entrusted with the monitoring of systemic risks closely monitor vulnerabilities related to household indebtedness, overvaluation of house prices and lending standards for new mortgage loans over the medium term, including, inter alia, by:
 - a) assessing — using loan-level data for new mortgage loans — the ability of borrowers taking out new mortgage loans to withstand adverse economic or financial conditions or adverse developments in the residential real estate market; and
 - b) assessing the sustainability of house prices and the potential for their decrease in the event of adverse economic or financial conditions.
2. It is recommended that, in order to prevent the excessive accumulation of credit risk, the Danish authority entrusted with the activation of borrower-based measures activate additional, or tighten existing, borrower-based measures, if the results of the monitoring carried out pursuant to point (a) of sub-Recommendation B(1) provide evidence that a significant or an increasing share of borrowers taking out new mortgage loans might not be able to service their debt or maintain consumption under adverse economic or financial conditions or following adverse developments in the residential real estate market.
3. It is recommended that Denmark increase the legally binding minimum down payment requirement, if the results of the monitoring carried out pursuant to paragraph 1(b) provide evidence that the overvaluation of house prices has increased, in order to ensure that collateral for new mortgage loans is sufficient to cover credit losses corresponding to the potential decrease in house prices under adverse economic or financial conditions and to the estimated decrease in house prices in the event of a negative scenario.

Recommendation C — Structural changes related to mortgage loans and the residential real estate sector

It is recommended that Denmark review its policies with the aim of curbing the structural factors that have driven the vulnerabilities identified in Denmark as a source of systemic risk as they provide incentives for households to take on excessive mortgage debt, or cause excessive growth in house prices and mortgage debt.

SECTION 2

IMPLEMENTATION**1. Definitions**

For the purposes of this Recommendation the following definitions apply:

- (a) 'borrower-based measures' means macroprudential measures that target borrowers;
- (b) 'direct control' means a real and effective capacity to impose and modify, where necessary to achieve an ultimate or intermediate objective, macroprudential measures applicable to the financial institutions that are under the scope of action of the corresponding macroprudential authority;
- (c) 'recommendation powers' means the capacity to guide, by means of recommendations, the application of macroprudential instruments, where necessary to achieve an ultimate or intermediate objective;
- (d) '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;
- (e) 'loan-to-value ratio' (LTV ratio) means the sum of all loans or loan tranches secured by the borrower on the immoveable property at the moment of loan origination relative to the value of the property at the moment of loan origination;
- (f) 'medium term' means within a three-year horizon;
- (g) 'macroprudential authority' means a national macroprudential authority with the objectives, arrangements, powers, accountability requirements and other characteristics set out in Recommendation ESRB/2011/3 ⁽⁸⁾;

⁽⁸⁾ Recommendation ESRB/2011/3 of the European Systemic Risk Board of 22 December 2011 on the macro-prudential mandate of national authorities (OJ C 41, 14.2.2012, p. 1).

- (h) 'debt-service' means the combined interest and principal repayment on a borrower's total debt over a given period (generally one year);
- (i) '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;
- (j) 'maturity' means the duration of the residential real estate loan contract expressed in years at the moment of loan origination.

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, of Recommendation B and of Recommendation C;
 - (b) when activating additional, or tightening existing, capital-based measures under Recommendation A, their calibration and phasing-in should take into account the position of Denmark in the economic and financial cycles, and any potential implications as regards the associated costs and benefits;
 - (c) when activating additional, or tightening existing, borrower-based measures under Recommendation B, their calibration and phasing-in should take into account the position of Denmark in the economic and financial cycles, and any potential implications as regards the associated costs and benefits;
 - (d) when increasing the minimum down payment requirement under Recommendation B, the calibration and phasing-in of such measure should take into account the position of Denmark in the economic and financial cycles, and any potential implications as regards the associated costs and benefits;
 - (e) as regards Recommendation C, when making policy changes, the phasing-in of such measures should take into account the position of Denmark in the economic and financial cycles, so that these measures do not serve to amplify or trigger the materialisation of accumulated vulnerabilities in the residential real estate sector in Denmark;
 - (f) specific criteria for compliance with Recommendation A, with Recommendation B and with Recommendation C are set out in Annex I.
2. The addressees of this Recommendation are requested to report to the ESRB and to the Council 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, overvaluation of house prices 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 profiles, 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

The addressees of this Recommendation are requested to report to the ESRB and to the Council on the actions taken in response to this Recommendation, or adequately justify any inaction, in compliance with the following timelines:

(a) Recommendation A

By 31 October 2020, and yearly thereafter until 31 October 2022, the addressee of Recommendation A is requested to submit to the ESRB and to the Council a report on any actions taken with regard to implementing capital-based measures. Where there is more than one body responsible for taking actions to address the vulnerabilities identified, one joint report should be submitted.

⁽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).

(b) *Recommendation B*

By 31 October 2020, and yearly thereafter until 31 October 2022, the addressees of Recommendation B are requested to submit to the ESRB and to the Council a report on monitoring vulnerabilities related to household indebtedness and actions taken to address such vulnerabilities. Where there is more than one body responsible for taking actions to address the vulnerabilities identified, one joint report should be submitted.

(c) *Recommendation C*

By 31 October 2022, the addressee of Recommendation C is requested to deliver to the ESRB and to the Council a report on the implementation of Recommendation C. Where there is more than one body 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, 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. Three assessments will be initiated as follows:
 - (i) by 31 December 2020, regarding the implementation of Recommendations A and B;
 - (ii) by 31 December 2021, regarding the implementation of Recommendations A and B; and
 - (iii) by 31 December 2022, regarding the implementation of Recommendations A, B and C.

2. The General Board will assess the actions and justifications reported 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, 27 June 2019.

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

ANNEX I

SPECIFICATION OF COMPLIANCE CRITERIA APPLICABLE TO THE RECOMMENDATIONS

Recommendation A — Activation or tightening of capital-based measures

The following compliance criteria are applicable to Recommendation A.

1. Prior to activating additional, or tightening existing, capital-based measures, an assessment should be made of the position of Denmark in the economic and financial cycles in order to determine whether activating such measures would be appropriate.
2. 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 Denmark; 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 B — Monitoring of vulnerabilities and activation or tightening of borrower-based measures

The following compliance criteria are applicable to Recommendation B.

1. Prior to activating additional, or tightening existing, borrower-based measures, an assessment should be made of the position of Denmark in the economic and financial cycles in order to determine whether such activation or tightening would be appropriate.
2. Prior to increasing the existing minimum down payment requirement, an assessment should be made of the position of Denmark in the economic and financial cycles in order to determine an appropriate calibration and phasing-in of the measure.

Recommendation C — Structural changes related to mortgage loans and the residential real estate sector

The following compliance criterion is applicable to Recommendation C.

When formulating policy options, and before implementing any policy changes, an assessment should be made of the impact of the proposed measures considering the position of Denmark in the economic and financial cycles, to ensure that such measures do not amplify or trigger the materialisation of the accumulated vulnerabilities in the residential real estate sector in Denmark.
