

**WARNING OF THE EUROPEAN SYSTEMIC RISK BOARD**  
**of 22 September 2016**  
**on medium-term vulnerabilities in the residential real estate sector of Denmark**  
**(ESRB/2016/07)**  
(2017/C 31/04)

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 macroprudential oversight of the financial system and establishing a European Systemic Risk Board <sup>(1)</sup>, and in particular Articles 3 and 16 thereof,

Whereas:

- (1) Past experience in many countries shows that the manifestation of residential real estate vulnerabilities may lead to significant risks to domestic financial stability and serious negative consequences for the real economy, as well as potentially leading to negative spill-overs to other countries.
- (2) The European Systemic Risk Board (ESRB) has recently concluded a systematic and forward-looking Union-wide assessment of vulnerabilities relating to residential real estate. In this context, the ESRB has identified in eight countries certain medium-term vulnerabilities as a source of systemic risk to financial stability, which may have the potential for serious negative consequences for the real economy.
- (3) The ESRB's vulnerability assessment highlights the following for Denmark:
  - a. The robustly increasing residential real estate prices combined with highly indebted households are the key vulnerabilities related to residential real estate in Denmark. Residential real estate prices, in particular in the major cities, have been increasing robustly for some time and in real terms are now close to the levels they had prior to the financial crisis. However, in general, prices do not appear to be overvalued.
  - b. The average level of indebtedness of Danish households is among the highest in the world. The existence of a well-developed financial system in Denmark for many years has made it possible for Danish households to have access to mortgage credit relatively easy and it has been inexpensive to borrow against housing wealth, mainly due to the large covered bond market that is subject to a 'balance principle' <sup>(2)</sup>. At the same time, Danish households have considerable pension wealth which reduces the need for individuals to be debt-free when they retire. However, some groups of households are highly indebted. For example, approximately one third of all Danish homeowners have total debt levels that exceed the value of their homes <sup>(3)</sup>, and approximately one quarter have total debt levels that are over three times higher than their annual pre-tax income. In addition, three quarters of households with a high debt level have a variable rate mortgage loan, which makes them vulnerable to any future interest rate increases.
  - c. The rapid increase in residential real estate prices in urban areas may translate into more individuals, such as first-time buyers, taking on considerable mortgage loans to purchase residential real estate. Thus, there is a risk that the current situation could lead to a further increase in household indebtedness. Robust increases in residential real estate prices are also fuelled by a number of structural factors, such as a highly regulated rental market and a procyclical housing tax system.
  - d. Although there are certain developments in the Danish mortgage market that are expected to decrease the risks related to the residential real estate sector, in particular the tightening of credit standards, the generally muted growth of credit and the decreasing share of mortgage loans that are non-amortising, interest-only loans are still common and there is continued credit growth in the major cities. Thus, the share of households that are highly indebted is likely to persist in the foreseeable future.

<sup>(1)</sup> OJ L 331, 15.12.2010, p. 1.

<sup>(2)</sup> Meaning there is match funding between the bonds and the mortgage loans issued by mortgage credit institutions.

<sup>(3)</sup> Other types of assets, for example cars, might also be pledged as collateral, but this is not reported in the figures being referred to here.

- e. Studies estimate that the vast majority of Danish households with high debt levels are financially robust even in stressed scenarios. However, studies also find a strong negative relationship between households' debt levels and changes in their consumption during stressed periods through both income and wealth effects. Furthermore, the combination of high levels of indebtedness and a high share of mortgages with variable rates means that even small changes in interest rate levels can have a strong impact on households' disposable income. In addition, the rapid growth in residential real estate prices increases the likelihood and magnitude of any future price fall, which, combined with the high levels of indebtedness, could leave a number of households in a situation where the value of their assets is below the value of their debt. While the net financial assets of Danish households are high, the liquidity and value of these assets may decrease in a stressed scenario, and households may not be willing to draw on their financial assets to maintain their levels of consumption.
- f. A large reduction in private consumption could lead to macroeconomic instability, which did indeed occur in Denmark in the aftermath of the global financial crisis. Further, the interconnectedness between banks across the Nordic-Baltic region means that there could be significant cross-border spill-overs between banking systems as a result of difficulties related to residential real estate stresses in any of the countries of the region. Currently, direct risks to the banking system appear to be limited since a number of structural and institutional features in Denmark limit credit risk (such as full recourse loans, personal bankruptcy legislation and beneficial social safety nets). Furthermore, the banking sector appears to be resilient should such risks crystallise: Danish banks are generally well-capitalised, and the major banks already comply with the additional capital requirements that are being phased-in over the coming years.
- g. The ESRB notes the measures introduced by the Danish authorities, including the limit on the loan-to-value ratio, the guidelines on cautious lending for banks and mortgage credit institutions, the gradual reduction in tax deductibility and the so-called 'supervisory diamond' for mortgage credit institutions<sup>(1)</sup>. While these policy measures are appropriate given the nature of the residential real estate vulnerabilities in Denmark, they may not be sufficient to fully address them. Even though mortgage lenders have themselves reported a tightening in lending standards, this has not yet had a noticeable impact on the level of household indebtedness or the real estate prices — on the contrary both credit and prices are still increasing in the major cities. In the light of the robust residential real estate price increases, particularly in the main cities, there is a risk that these developments could lead to a further increase in household indebtedness. Moreover, the high level of household debt is not expected to significantly decline since it is not directly addressed by these policies. It is important to note that this assessment reflects the fact that some of the measures have only been in effect for a limited period of time and are entering into force gradually, while some of them only affect new borrowers,

HAS ADOPTED THIS WARNING:

The ESRB has identified medium-term vulnerabilities in the residential real estate sector of Denmark as a source of systemic risk to financial stability, which may have the potential for serious negative consequences for the real economy. From a macroprudential perspective, the ESRB considers the main vulnerabilities to be the robustly increasing residential real estate prices — in particular in the major cities — in combination with highly indebted households. In addition, if risks were to materialise, there could be potential spill-over effects to other countries in the Nordic-Baltic region.

Done at Frankfurt am Main, 22 September 2016.

Francesco MAZZAFERRO

*Head of the ESRB Secretariat*

*On behalf of the General Board of the ESRB*

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<sup>(1)</sup> The supervisory diamond sets out a number of benchmarks that the Danish FSA generally considers to indicate mortgage-credit activities that have a higher risk profile. It consists of five indicators with corresponding limits on the risks of the institutions: large exposures; lending growth; interest rate risk of the borrower; interest-only lending; short-term funding.