

**WARNING OF THE EUROPEAN SYSTEMIC RISK BOARD**  
**of 22 September 2016**  
**on medium-term vulnerabilities in the residential real estate sector of the United Kingdom**  
**(ESRB/2016/12)**  
(2017/C 31/09)

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 <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 the United Kingdom:
  - a. The uncertainty following the UK's referendum on European Union membership on 23 June 2016 may have caused a turning point in the UK residential real estate market.
  - b. In the immediate aftermath of the referendum, house builders' share prices and consumer confidence dropped sharply. Residential real estate prices fell by 0,2 % in July 2016 on a month-on-month basis, however price growth picked up again in August 2016 to + 0,2 % on a month-on-month basis.
  - c. Before the referendum, the main vulnerabilities associated with residential real estate in the UK related to the high level of household indebtedness and residential real estate prices that had been rising for several years, and the potential for one to reinforce the other.
  - d. In particular, the debt of households in relation to their income and to the size of the economy is elevated compared to other Union countries. Whilst this may be partly due to structural factors, such as a highly developed banking system and a structural shortage of housing in the UK, it may also be an indicator of elevated risks. Risks associated with the high level of household indebtedness are partly mitigated by the fact that the aggregate household debt-to-income ratio fell between 2008 and 2012/13 and has remained flat since then. In addition, the share of households with very high levels of debt relative to their income has declined over recent years and new borrowing at high loan-to-income ratios has declined somewhat recently.
  - e. Nominal residential real estate prices exceeded their pre-crisis peak in 2015, although in real terms prices are lower than their pre-crisis peak. Moreover, residential real estate prices have become decoupled from rent and income growth rates: in recent years, house price growth has been more than three times income growth and the price-to-rent ratio has increased steeply since late 2012.
  - f. Following the referendum, the Bank of England and some international institutions have revised down the outlook for the UK economy and housing market. The Bank of England now expects aggregate house prices to decline a little over the next year, and the level of mortgage approvals to be lower. If that forecast proves to be correct, it would slow the pace of build-up in mortgage debt and therefore reduce vulnerabilities in the medium-term. However, an economic slowdown could lead to the crystallisation of some of the abovementioned risks such as, for example, if unemployment increases and/or income growth falls then some households may find it more difficult to service their debts.

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

- g. Moreover, if an adverse scenario for the economy does materialise, the associated negative household income and wealth effects may reinforce the initial shock with negative direct and indirect effects on financial stability (e.g. if households need to reduce consumption in order to service their mortgage loans, or if mortgage defaults increase). In addition, the growing and sizeable buy-to-let sector in the UK has the potential to amplify a downturn in the housing market as buy-to-let investors are more likely to sell if house prices are expected to fall.
- h. On 3 August 2016, the Bank of England introduced a package of measures to support the economy, including an interest rate reduction, and measures to ensure that lower interest rates pass through to the real economy. These measures should support mortgages and the housing market and may mitigate risks in a downturn scenario.
- i. Conversely, it is also possible that the slowdown in the housing market could prove to be temporary and, after some time passes, house prices, mortgage approvals and household debt may begin to grow again. In this scenario, vulnerabilities related to residential real estate would continue to increase. Before the referendum, the Financial Policy Committee, Prudential Regulation Authority and Financial Conduct Authority had implemented a number of policy measures targeted at reducing and containing such residential real estate vulnerabilities, including those stemming from the build-up of household indebtedness. The measures have shown signs of improving mortgage resilience.
- j. Specifically with respect to the banking system, the Bank of England has taken action to ensure that the UK banking system is resilient to a very large housing market shock. The stress tests conducted by the Bank of England in recent years assessed the resilience of the banking system relative to considerably more severe scenarios than those that are currently expected. These stress tests ensured that banks were capitalised not just to withstand the stress but also to maintain the supply of lending throughout. Based on this analysis, it seems that the UK banking system would be resilient enough to withstand a housing market shock if the abovementioned vulnerabilities were to crystallise in the near-term.
- k. Overall, the UK residential real estate market is potentially at a turning point. Given the uncertainty of the implications of the UK's referendum on European Union membership, it is not yet possible to judge whether the vulnerabilities that had accumulated will now begin to crystallise or whether, in time, they might instead continue to grow. The appropriate policy response is likely to differ between these two scenarios. Therefore, it will be important for the UK authorities to monitor developments closely and adjust macroprudential policy as necessary in light of these. Looking ahead, it will be necessary to ensure that any adjustment in the housing market proceeds at an appropriate pace and that new vulnerabilities do not emerge,

HAS ADOPTED THIS WARNING:

The ESRB has identified medium-term vulnerabilities in the residential real estate sector of the United Kingdom as a source of systemic risk to financial stability, which may have the potential for serious negative consequences for the real economy. Currently, there is a high degree of uncertainty about the medium-term outlook for the UK housing market. However, from a macroprudential perspective, the ESRB considers there to be risks under different housing market scenarios — either through the crystallisation of accumulated vulnerabilities, particularly related to household indebtedness and the interaction with elevated residential real estate prices, or through the further build-up of vulnerabilities. The appropriate policy response is likely to differ between these two scenarios. Therefore, it will be important for the UK authorities to monitor developments closely and adjust macroprudential policy as necessary in light of them.

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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