

WARNING OF THE EUROPEAN SYSTEMIC RISK BOARD
of 27 June 2019
on medium-term vulnerabilities in the residential real estate sector in the Czech Republic
(ESRB/2019/10)
(2019/C 366/07)

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 and 18 thereof,

Whereas:

- (1) Housing is a key sector of the real economy and represents a major part of household wealth and bank lending. Residential real estate properties make up a large component of households' asset holdings and loans for housing are often a large part of the balance sheets of credit institutions. Furthermore, housing construction is typically an important element of the real economy, being a source of employment, investment and growth.
- (2) Past financial crises and experience in many countries 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 in a given country, which may also lead to negative cross-border spillovers. The effects on financial stability may be both direct and indirect. Direct effects consist of credit losses from mortgage portfolios due to adverse economic and financial conditions and simultaneous negative developments in the residential real estate market. Indirect effects relate to adjustments in household consumption, with further consequences for the real economy and financial stability.
- (3) Real estate markets are prone to cyclical developments. Excessive risk-taking, excessive leverage and misaligned incentives during the upturn of the real estate cycle may lead to severe negative implications for both financial stability and the real economy. Given the relevance of residential real estate (RRE) for financial and macroeconomic stability, seeking to prevent the build-up of vulnerabilities in residential real estate markets by the use of macroprudential policy is especially important, in addition to its use as a means of mitigating systemic risk.
- (4) While cyclical factors play an important role in fuelling the vulnerabilities identified in residential real estate markets in the European Economic Area (EEA) countries, there are also structural factors that have driven these vulnerabilities. These factors can include a lack of housing supply – which has been exerting upward pressure on house prices and debt for households that buy their own property – or other public policies which may act as an incentive for households to overborrow. Given that these factors go beyond macroprudential policy, measures originating from other policy areas can complement and support the current macroprudential measures in addressing the vulnerabilities present in the residential real estate markets in the individual countries efficiently and effectively, without generating excessive costs for the real economy and the financial system.

⁽¹⁾ OJ L 331, 15.12.2010, p. 1.

- (5) In 2016, the European Systemic Risk Board (ESRB) conducted a Union-wide assessment of medium-term vulnerabilities relating to residential real estate ⁽²⁾. 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: Belgium ⁽³⁾, Denmark ⁽⁴⁾, Luxembourg ⁽⁵⁾, the Netherlands ⁽⁶⁾, Austria ⁽⁷⁾, Finland ⁽⁸⁾, Sweden ⁽⁹⁾ and the United Kingdom ⁽¹⁰⁾.
- (6) The ESRB has recently concluded a systematic and forward-looking EEA-wide assessment of vulnerabilities relating to residential real estate ⁽¹¹⁾.
- (7) In this context, the ESRB has identified in eleven countries, of which the Czech Republic is one, certain medium-term vulnerabilities as sources of systemic risk to financial stability that have not been sufficiently addressed.
- (8) The ESRB takes note of the macroprudential action taken by the Czech Republic in order to mitigate the systemic risk from the residential real estate sector and it suggests that the relevant Czech authorities should stand ready to take further action in the event that the current macroprudential policy stance should prove to be insufficient.
- (9) The ESRB's assessment of vulnerabilities highlights the following in relation to the Czech Republic:
- a. The growth in house prices has outpaced the growth in household income over the medium term, and cannot be fully justified by developments in the debt-servicing capacity of households. Česká národní banka (CNB) estimates that as of the second half of 2018, house prices in the Czech Republic were overvalued by between 10 % and 15 %. In addition to the contribution from cyclical factors, there are important structural factors that may have contributed to this overvaluation. In particular, the slow pace of work on the future Metropolitan Plan in Prague and delays in issuing building permits may also have contributed to the shortage in housing supply, especially in the capital.
 - b. The overvaluation of house prices, which continues to increase, coupled with high growth in housing loans and the loosening of lending standards in recent years have increased the possibility of credit losses from mortgage loans in the event of adverse economic and financial conditions or adverse developments in the residential real estate market, with direct effects on financial stability. Similarly, the increasing indebtedness of households, coupled with the growing share of households that are potentially vulnerable to adverse economic and financial conditions or adverse developments in residential real estate market may lead to households reducing their consumption in the event of an economic or financial shock, which could lead to second-round effects that would affect financial stability indirectly.
 - c. The annual growth in housing loans has been high over the medium term. Prior to the introduction of recommended limits to the loan-to-value (LTV) ratio, debt-to-income (DTI) ratio and debt-service-to-income (DSTI) ratio, the growth of housing credit was coupled with the loosening of lending standards as evidenced by the increasing percentage of loans with a high LTV ratio (of over 80 % and 90 %) and the increasing percentage of loans with high DTI and DSTI ratios (of over 8 % and 40 %, respectively). These loans were provided to households that may be vulnerable to adverse economic and financial conditions. Moreover, an increasing percentage of loans were provided that combined high LTV ratios with a high DTI ratio or DSTI ratio, thus further increasing the potential for credit losses related to these new mortgage loans. While the average risk weights for the mortgage portfolios held by credit institutions in the Czech Republic using the internal ratings-based approach can be regarded as being relatively high in comparison to other EEA countries, these risk weights have been declining.

⁽²⁾ See 'Vulnerabilities in the EU Residential Real Estate Sector', ESRB, November 2016, available on the ESRB's website at www.esrb.europa.eu.

⁽³⁾ Warning ESRB/2016/06 of the European Systemic Risk Board of 22 September 2016 on medium-term vulnerabilities in the residential real estate sector of Belgium (OJ C 31, 31.1.2017, p. 45).

⁽⁴⁾ 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).

⁽⁵⁾ Warning ESRB/2016/09 of the European Systemic Risk Board of 22 September 2016 on medium-term vulnerabilities in the residential real estate sector of Luxembourg (OJ C 31, 31.1.2017, p. 51).

⁽⁶⁾ Warning ESRB/2016/10 of the European Systemic Risk Board of 22 September 2016 on medium-term vulnerabilities in the residential real estate sector of the Netherlands (OJ C 31, 31.1.2017, p. 53).

⁽⁷⁾ Warning ESRB/2016/05 of the European Systemic Risk Board of 22 September 2016 on medium-term vulnerabilities in the residential real estate sector of Austria (OJ C 31, 31.1.2017, p. 43).

⁽⁸⁾ Warning ESRB/2016/08 of the European Systemic Risk Board of 22 September 2016 on medium-term vulnerabilities in the residential real estate sector of Finland (OJ C 31, 31.1.2017, p. 49).

⁽⁹⁾ Warning ESRB/2016/11 of the European Systemic Risk Board of 22 September 2016 on medium-term vulnerabilities in the residential real estate sector of Sweden (OJ C 31, 31.1.2017, p. 55).

⁽¹⁰⁾ Warning ESRB/2016/12 of the European Systemic Risk Board of 22 September 2016 on medium-term vulnerabilities in the residential real estate sector of the United Kingdom (OJ C 31, 31.1.2017, p. 57).

⁽¹¹⁾ See 'Vulnerabilities in the residential real estate sectors of EEA countries', ESRB, 2019, available on the ESRB's website at www.esrb.europa.eu.

- d. Although household indebtedness in the Czech Republic can be regarded as being moderate compared to other EEA countries, it has been increasing in line with the growth in housing loans. Despite the fact that recently there have been longer periods during which interest rates were fixed, a significant share of new mortgage loans were previously provided with initial rate fixation periods of less than five years. Consequently, a significant percentage of households taking out new mortgage loans may find it difficult to service their debt in the event of an interest rate increase.
- e. Adverse economic and financial conditions or adverse developments in the residential real estate market may lead to risks materialising as a result of some of the vulnerabilities mentioned above. For example, if the growth in household income decreases or interest rates increase, then highly indebted households may find it more difficult to service their loans. If these households default on their loans and house prices decrease at the same time, this may lead to credit losses from mortgage loans. Taking into account a previous Recommendation of CNB ⁽¹²⁾ related to lending standards for new mortgage loans, the risk of defaults and direct credit losses for credit institutions is currently expected to be limited. Moreover, given the relatively high average risk weights for the mortgage portfolios of credit institutions using the internal ratings-based approach and the relatively high capitalisation of the banking sector in the Czech Republic, credit institutions may be well-placed to absorb direct credit risk shocks related to the residential real estate sector. However, households may still need to adjust their consumption, as possible reductions in income or net wealth could lead to indirect effects on financial stability.
- f. The ESRB takes note of the wide range of borrower-based macroprudential measures to mitigate risks related to the residential real estate sector in the Czech Republic. The limits to the LTV ratio aim to address the build-up of vulnerabilities related to the provision of new mortgage loans in a market in which house prices are overvalued, with potential direct effects on financial stability. Furthermore, limits to the DTI ratio and the DSTI ratio aim to increase the effectiveness of the limits to the LTV ratio by limiting the provision of new loans to households that are potentially vulnerable to adverse economic and financial conditions and adverse developments in the residential real estate market in the Czech Republic. Credit providers are also recommended to stress-test the ability of debtors to withstand shocks related to increased interest rates or decreased incomes. To increase the resilience of institutions in relation to cyclical vulnerabilities, in 2018 CNB further increased the counter-cyclical capital buffer rate to 2 % (from 1,5 %), with effect from 1 July 2020.
- g. However, the current borrower-based measures have been introduced on the basis of a Recommendation from CNB which is not legally binding, and there is no legal framework in place to activate these measures through legally binding acts. As such, the effectiveness of the current measures cannot be guaranteed over the medium term, and during this period both the overvaluation of house prices and the growth in mortgage credit may increase further.
- h. The current macroprudential policy is assessed to be partially appropriate and partially sufficient as regards the potential development of vulnerabilities in the residential real estate sector in the Czech Republic over the medium term. It is important that national authorities have legally binding borrower-based measures at their disposal to provide them with the necessary powers to address potential financial stability vulnerabilities, including, in particular, powers to set legally binding limits to loan-to value ratios – and to either debt-to-income ratios or debt-service-to-income ratios, in combination with maturity limits – where necessary in relation to new housing loans. Only legally binding borrower-based measures would ensure that all credit providers, irrespective of their type or whether they are domestic or foreign, comply fully with the measures in place.

⁽¹²⁾ Recommendation of 12 June of 2018 on the management of risks associated with the provision of retail loans secured by residential property, available at <https://www.cnb.cz> (ÚS ČNB ze dne 12. června 2018 – Doporučení k řízení rizik spojených s poskytováním retailových úvěrů zajištěných rezidenční nemovitostí).

- (10) When activating any measures to address the identified vulnerabilities, their calibration and phasing-in should take into account the position of the Czech Republic in the economic and financial cycles, and any potential implications as regards the associated costs and benefits.
- (11) ESRB warnings 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 WARNING:

The ESRB has identified medium-term vulnerabilities in the residential real estate sector in the Czech Republic 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 high overvaluation of house prices coupled with the high growth in housing credit and loose lending standards, against the backdrop of the non-legally-binding nature of the borrower-based measures currently available and in place.

Done at Frankfurt am Main, 27 June 2019.

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