

WARNING OF THE EUROPEAN SYSTEMIC RISK BOARD
of 27 June 2019
on medium-term vulnerabilities in the residential real estate sector in Germany
(ESRB/2019/11)
(2019/C 366/08)

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 Germany is one, certain medium-term vulnerabilities as sources of systemic risk to financial stability that have not been sufficiently addressed.
- (8) The ESRB's assessment of vulnerabilities highlights the following in relation to Germany:
- Most of the residential real estate price indicators available indicate that house prices are overvalued in Germany. Similar to previous estimates made for 2016 and 2017, existing estimates for 2018 point to a significant overvaluation of house prices in urban areas. Following a period of gradual increases since 2010, nominal house price growth has accelerated in recent years, slightly outpacing the growth in household income. Furthermore, this growth has become more widespread in both urban and rural areas. House price increases in the large cities and urban areas reflect a shortage of housing supply relative to demand, and the German Federal Government has introduced a number of measures aimed at alleviating this shortage. Future movements in house prices are, therefore, likely to depend on the effects of these measures.
 - Despite a recent pick-up in new lending, the annual growth in housing credit has been moderate over the past three years. A comprehensive analysis of lending standards is currently hindered by the lack of detailed data on loan-to-value (LTV) ratios and on other credit ratios for newly granted loans. However, there is some evidence indicating that the demand for loans with high sustainable ⁽¹²⁾ LTV ratios has increased. Moreover, the ECB's euro area bank lending survey further suggests that in 2018 the surveyed banks have decreased their margins on loans for house purchases.
 - Household indebtedness can be considered moderate when compared with that in other Member States. However, even though the home ownership rate in Germany is the lowest in the European Union, the share of home owners with a mortgage represents around a quarter of the total population, which is close to the EU average. Although the growth in housing loans has been relatively moderate in the past, the increase in house prices is notable and could at some point be accompanied by a strong increase in newly granted housing loans. This could lead to further growth in overall household indebtedness over the medium-term.

⁽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.

⁽¹²⁾ The sustainable LTV ratio is the ratio between the amount of a real estate loan and the mortgage lending value attributed to the property in question. The latter is the value of the property as produced by a prudent assessment, taking into account the fundamental determinants of the value of the property. See section 16(2) of the Law on covered bonds (*Pfandbriefgesetz*).

- d. Adverse economic and financial developments may trigger or be triggered by sharp adjustments in the residential real estate market that could, in the context of cyclical vulnerabilities, lead to the materialisation of direct and indirect risks to financial stability, given the vulnerabilities mentioned above. Potential direct risks to the banking system in Germany relate both to possible defaults of loans granted in an environment of a long-lasting economic upswing and overvalued and strongly increasing house prices, and to competitive pressures that might lead to a loosening of credit standards and reductions in margins for new loans. Moreover, some households may experience a negative wealth effect or fall into negative equity if the decrease in house prices is significant. If, for example, unemployment increases and/or household income growth decreases, some households may find it more difficult to service their debts. The associated negative household income and wealth effects may reinforce the initial shock if households are required to reduce consumption in order to service their debt. This could lead to second-round effects and an increase in risks to credit institutions and the financial system.
- e. However, it is noted that the long periods over which mortgage interest rates are fixed serve to mitigate the risk posed by increasing interest rates for borrowers. Given the positive income prospects for private households and the persistent favourable labour market conditions, potential risks from households having to stretch themselves financially appear to be rather low. It should be noted, however, that the interest rate risk from the long rate fixation periods lies with the credit institutions and this is one of the cyclical vulnerabilities of the banking system.
- f. The ESRB takes note of the fact that the *Bundesanstalt für Finanzdienstleistungsaufsicht* (the Federal Financial Supervisory Authority – BaFin) has announced that the *Ausschuss für Finanzstabilität* (the Financial Stability Committee) recommended the activation of a countercyclical capital buffer rate of 0,25 % in order to build up the resilience of institutions in a preventive manner. BaFin intends to activate the countercyclical capital buffer in the recommended manner. The recommended calibration has taken into account the credit dynamics in Germany, which are accompanied by strong residential property price dynamics. However, it is not expected to curb housing credit growth or halt a potential deterioration in lending standards. The national authorities have been monitoring credit conditions, but there has been no formal guidance from them on what prudent standards should include.
- g. The current policy measures are assessed to be partially appropriate and partially sufficient to mitigate the identified systemic risks related to vulnerabilities in the residential real estate sector. Germany could activate further capital-based measures requiring credit institutions to create additional capital buffers to increase the resilience of the banking system to cyclical risks and vulnerabilities (i.e. credit risk and interest rate risk) that might have accumulated, given the long-lasting economic upswing and also the rapidly evolving housing price dynamics. In view of the significant house price overvaluation in the urban areas of Germany that has already existed for several years, as well as uncertainty regarding lending standards, Germany could contribute to ensuring sound lending standards in relation to new loans in an appropriate manner (e.g. through a recommendation or activation of legally binding limits to LTV ratios, if the legal conditions for activation are met), in order to prevent a build-up of vulnerabilities, thereby fostering financial stability.
- h. As already proposed by the *Ausschuss für Finanzstabilität* in 2015 ⁽¹³⁾, it is also important that national authorities have all necessary macroprudential instruments 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. Currently, the income-based instruments are, however, not available in Germany. Although the national authorities do have the power to set legally binding loan-to-value limits if deemed necessary to guarantee financial stability, this is conditional on the identification of risks to financial stability stemming from a strong increase in house prices and mortgage lending accompanied by a substantial loosening of lending standards. The current data gaps with regard to lending standards for new mortgage loans should therefore also be closed, so as to improve the ability to identify those risks and to address them when needed – such an initiative is a necessary addition to the German macroprudential monitoring framework.

⁽¹³⁾ Recommendation AFS/2015/1 on new instruments for regulating loans for the construction or purchase of residential real estate (*Empfehlung AFS/2015/1 vom 30. Juni 2015 zu neuen Instrumenten für die Regulierung der Darlehensvergabe zum Bau oder Erwerb von Wohnimmobilien*).

- (9) When activating any measures to address the identified vulnerabilities, 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.
- (10) 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 Germany 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 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, in the context of the overall uncertainty regarding lending standards for housing loans due to the significant data gaps.

Done at Frankfurt am Main, 27 June 2019.

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