

WARNING OF THE EUROPEAN SYSTEMIC RISK BOARD
of 27 June 2019
on medium-term vulnerabilities in the residential real estate sector in France
(ESRB/2019/12)
(2019/C 366/09)

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 ⁽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 take on additional debt. 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 France 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 France:
- a. Household indebtedness in France is relatively high in relation to disposable income. It has grown significantly over the past 10 years and the recent medium-term dynamics indicate that this trend could continue. The main risks associated with such a level of household indebtedness are the possibility of a contraction of consumption and second-round effects to financial stability in the event of a macroeconomic shock. However, some mitigating factors are present in the French economy. First, households have a high savings rate by international comparison. Second, important social safety nets exist which aim at mitigating the impact of a sudden decrease in borrowers' income in the event of unemployment, thus reducing the potential second-round effects of a macroeconomic shock. Third, a high percentage of borrowers are not exposed to interest rate risk due to the high proportion of fixed-rate housing loans.
 - b. The growth in housing loans has been relatively strong, both over the short and medium term. The increase in new housing loans is notable and this could lead to further growth in overall household indebtedness. Moreover, some indicators suggest that certain households with housing loans in France may be vulnerable to economic and financial shocks, in particular young and lower-income households with higher debt-service-to-income (DSTI) ratios. In addition, around a third of the new housing loans have a loan-to-value (LTV) ratio of over 95 % and the average loan-to-income ratio for new loans reached a historical peak in 2017. The average maturity of housing loans has also increased, while the distribution of DSTI ratios has deteriorated. Preliminary microdata used by the French authorities to monitor these developments suggest that a large share of high-LTV or high-DSTI borrowers are wealthy households whose loans are backed by collateral and guarantees.

⁽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.

- c. While there is no strong evidence of widespread house price overvaluation in France, residential real estate prices have increased significantly in some large cities ⁽¹²⁾ – the Paris area in particular – and this may have eroded housing affordability in some locations. At the local level, there is some indication that residential real estate prices are elevated, relative to income and rents. Given that a third of all loans granted have a high LTV ratio and that in the future house prices could adjust, some households may experience a negative wealth effect. However, direct credit losses from a potential decrease in the collateral values of mortgage loans, are expected to be low due to several country-specific factors. First, the use of the guarantee scheme to collateralise housing loans ⁽¹³⁾ mitigates the direct credit risk to credit institutions in the event of a decrease in house prices. Second, the potential wealth effects for households are estimated to be weaker than in other advanced economies as there is no possibility to withdraw cash or equity from house revaluations.
- d. Adverse economic and financial conditions or adverse developments in the residential real estate market could 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 France relate both to the potential defaults of loans granted in an environment of strongly increasing house prices and low interest rates, and to indebted households and competitive pressures leading to some loosening of lending standards and narrowing of margins. In France a number of factors, such as the collateral channel which is expected to be relatively weak, important social safety nets and the prevalence of fixed-rate loans, are expected to mitigate direct credit risks related to housing market shocks. However, 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 housing loans. This could lead to second-round effects and an increase in the risks to credit institutions and the financial system.
- e. The ESRB takes note of the fact that France has announced a 0,5 % countercyclical capital buffer rate to build up the resilience of institutions in a preventive manner. The calibration of this macroprudential measure took into account the indebtedness of the non-financial sector in France more broadly and that of the household sector more specifically, as household lending is also supported by the recovery of residential property prices. Therefore, the capital measure is expected to enhance the banking sector's resilience to the accumulated vulnerabilities. However, it is not expected to curb either the dynamics of household indebtedness or the deterioration in lending standards. Although the national authorities in France have been monitoring credit conditions, there has been no formal guidance on what should be considered as prudent credit conditions.
- f. 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 in France. In particular, the current capital-based macroprudential measures in place could be complemented by other measures to tackle the vulnerabilities related to increasing household indebtedness and to the signs of deteriorating lending standards. The ESRB acknowledges the efforts made by the French authorities to monitor risks in the residential real estate sector as well as their aim to further improve the monitoring framework in accordance with Recommendation ESRB/2016/14 of the European Systemic Risk Board ⁽¹⁴⁾. Notwithstanding this, further actions may be needed to address the vulnerabilities identified in France. In particular, given the rising household indebtedness and signs of deteriorating lending standards, the national authorities in France could consider the need for additional pre-emptive actions such as explicit guidelines for lending standards, in the form of either a recommendation or formal borrower-based measures.

⁽¹²⁾ INSEE, (last data Q4 2018) available at <https://www.insee.fr/fr/statistiques/3733241>, with data for Paris, Lyon and Marseilles in particular.

⁽¹³⁾ The guarantors are financial institutions or insurance companies owned by one or more credit institutions; in all cases, they are regulated bodies supervised by the *Autorité de contrôle prudentiel et de résolution* (the French Prudential Supervision and Resolution Authority).

⁽¹⁴⁾ 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).

- (9) When activating any measures to address the identified vulnerabilities, their calibration and phasing-in should take into account the position of France in the economic and financial cycles, and 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 France 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 high and increasing household indebtedness associated with a recent deterioration in lending standards.

Done at Frankfurt am Main, 27 June 2019.

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