WARNING OF THE EUROPEAN SYSTEMIC RISK BOARD

of 2 December 2021

on medium-term vulnerabilities in the residential real estate sector of Liechtenstein

(ESRB/2021/14)

(2022/C 122/05)

THE GENERAL BOARD OF THE EUROPEAN SYSTEMIC RISK BOARD,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to the Agreement on the European Economic Area ([1]), in particular Annex IX thereof,

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 ([2]), and in particular Article 3(2)(c) and Articles 16 and 18 thereof,

Having regard to Decision ESRB/2011/1 of the European Systemic Risk Board of 20 January 2011 adopting the Rules of Procedure of the European Systemic Risk Board ([3]), and in particular Article 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 (RRE) properties make up a large component of households' asset holdings and loans for housing are often a large part of banks' balance sheets. Furthermore, housing construction is typically an important component of the real economy, as 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 any 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 RRE market. Indirect effects relate to adjustments in household consumption, with further consequences for the real economy and for 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 RRE for financial and macroeconomic stability, seeking to prevent the build-up of vulnerabilities in RRE 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 RRE markets in European Economic Area (EEA) countries, structural factors have also driven these vulnerabilities. These structural factors can include a lack of housing supply, which has exerted upward pressure on house prices and debt for households that buy their own property, and other public policies that 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 RRE markets in individual countries efficiently and effectively, without generating excessive costs for the real economy and the financial system.

([1]) OJ L 1, 3.1.1994, p. 3.
([2]) OJ L 331, 15.12.2010, p. 1.
([3]) OJ C 58, 24.2.2011, p. 4.

(5) The outbreak of the COVID-19 pandemic in 2020 and the related crisis have not led to a cyclical decline in housing markets. Rather, following a period of gradual growth, and amidst the low interest rate environment, real house price and lending growth have accelerated further in several countries, largely outpacing the growth in household income. In order to mitigate the impact of the pandemic and the resulting economic uncertainty, various measures and policies, such as moratoria and public guarantees, have been implemented. In this broad policy context, previously scheduled macroprudential measures have been temporarily relaxed or their activation delayed in some countries. The currently observed improvement in the economic situation allows for an adjustment of macroprudential policy in those countries in which RRE-related vulnerabilities have continued to build up.

(6) The European Systemic Risk Board (ESRB) has recently concluded a systematic and forward-looking EEA-wide assessment of vulnerabilities relating to RRE.

(7) As regards Liechtenstein, this recent assessment has revealed that:

a. Household indebtedness in Liechtenstein was equivalent to 226 % ([4]) and 120 % of disposable income and gross domestic product (GDP) respectively in 2020 according to Financial Market Authority (FMA) estimates, ranking Liechtenstein among the countries with the highest household indebtedness in the EEA. Moreover, household debt has recently been trending upward. Apart from the favourable costs of debt financing, perceived tax incentives might have contributed to the accumulation of household debt ([5]). An analysis conducted by the FMA shows that indebtedness is unevenly distributed across households, with 14 % of households reporting debt between CHF 500 000 and CHF 1 million, and 9 % of households reporting debt exceeding CHF 1 million, according to the tax statistics. Furthermore, the share of households with a debt-to-income (DTI) ratio above five is relatively high, suggesting that elevated household debt is not always accompanied by greater household income. On a more positive note, the high share of fixed interest rate mortgages is an important mitigant to the risks related to household indebtedness.

b. The housing market dynamic has remained moderate in recent years. Given the legal restrictions on the purchase of real estate ([6]), transaction activity is typically low in Liechtenstein. No price indices are published by the public authorities. Nevertheless, according to the FMA, price data from expert assessments indicates only moderate increases in the prices of both land and apartments. Similarly, building activity and transaction activity have also remained relatively stable in recent years.

c. According to the FMA, mortgage growth (including RRE and other real estate loans of domestic banks in the Swiss franc currency area) has recently been on a declining trend and nominally stood at 0,7 % in 2019 (down from 8,8 % in 2010), with a slight uptick to 2,5 % in 2020. Annual growth in domestic RRE loans was even weaker, amounting to 1,1 % in 2020.

d. According to the FMA, a relatively prudent approach has been taken to the provision of mortgage loans in terms of loan-to-value (LTV) ratios, with only a negligible share of both existing and new mortgages having an LTV ratio higher than 80 % in 2019 and 2020. Banks are also required to report loans as 'exceptions to policy' whenever they overrule their internal guidelines with respect to mortgage affordability. In practice, banks verify whether an interest rate increase to 4,5 % or 5 % would imply a debt service burden exceeding a third of household income. In the light of the current low interest rate environment and the history of low interest rates in the Swiss franc currency area the burden of complying with such requirements is quite severe. However, around 23 % of total RRE loans in Liechtenstein belonged to this 'exceptions to policy' category as of the end of 2020.

e. The total volume of domestic RRE loans amounted to roughly 85 % of GDP in 2020, which is one of the highest ratios in the EEA. However, the size of the Liechtenstein's banking sector corresponds to roughly 15 times the country's GDP, which means that while mortgage loans are a source of income for some Liechtenstein banks, domestic loans are not paramount for the profitability and solvency of the banks operating in Liechtenstein as

([4]) The debt-to-income and debt-to-GDP ratios for Liechtenstein are only approximately comparable to other EEA countries. Disposable income in Liechtenstein is calculated as the difference between total taxable income and the wealth and income tax. Furthermore, the total household debt figure is based on tax statistics and debt is not defined on a consolidated basis (i.e. credit within the household sector or even within the family is also included). This definitional issue inflates the headline number relative to other EEA countries.

([5]) In particular, the tax base for households also includes a hypothetical yield on net wealth (currently set at 4 %) which is added to annual earned income. In order to reduce their net wealth, households may keep their mortgage in place instead of repaying it. In practice, however, the tax incentive to do so is quite small, particularly considering the interest rate on the non-amortised debt that still needs to be paid.

([6]) There are restrictions on the purchasing of housing in Liechtenstein where there is an absence of a legitimate interest, e.g. in respect of existing property. About half of the real estate transactions in Liechtenstein are not purchases, but instead transfers by barter, donation or heritage.

they mainly focus on private banking services. At the same time, Liechtenstein's banking sector is well capitalised, with the Common Equity Tier 1 (CET1) capital ratio standing at 22,3 % in June 2021. Additionally, Liechtenstein's banking sector is characterised by very strong liquidity indicators, with the extremely low loan-to-deposit ratio of 65 % implying low funding risk.

f. Given the conservative LTV ratios of domestic mortgage loans, their limited share in banks' portfolios, and the high capitalisation of the banking sector, direct risks to financial stability stemming from the RRE sector are currently limited in Liechtenstein. However, while the labour market in Liechtenstein has proven to be resilient during times of recession over the past decades, and household wealth remains relatively high, the already high and increasing level of household debt nonetheless makes the household sector vulnerable to unexpected macroeconomic shocks. If the level of unemployment increases and/or household income decreases, some households may find it more difficult to service their debts than they do now. The associated negative effects on household income and wealth may reinforce the initial macroeconomic shocks if households are required to reduce consumption in order to service their debt. This could lead to second-round effects and an increase in the risks to credit institutions and the financial system ([7]).

g. The ESRB acknowledges that several measures aimed at the mitigation of the current RRE vulnerabilities are in place in Liechtenstein, including, in particular, the LTV limit of 80 %, the requirement to amortize mortgages to a maximum LTV ratio of 66 % within the first 20 years of loan repayment, and increased risk weights on mortgages for banks applying the Standardised Approach for the calculation of own funds requirements ([8]). At the same time, the FMA is implementing Recommendation ESRB/2016/14 of the European Systemic Risk Board ([9]). The new data, which will be available in the second half of 2022, are expected to further improve the analysis of RRE vulnerabilities in Liechtenstein.

h. From a forward-looking perspective and taking into account the medium-term risk outlook, the current macroprudential policy mix is considered to be partially appropriate and partially sufficient. Given the already high and increasing level of household debt, and the considerable share of households that are vulnerable to unexpected negative shocks, the existing limit to the LTV ratios should be complemented by income-related borrower-based measures to prevent further accumulation of RRE vulnerabilities. To this end, a legal basis for borrower-based instruments may need to be created, thus providing sufficient flexibility to the national authorities to address the RRE vulnerabilities in Liechtenstein.

(8) When activating any measures to address the identified vulnerabilities, their calibration and phasing-in should take into account Liechtenstein's position in the economic and financial cycles, and any potential implications as regards associated costs and benefits,

HAS ADOPTED THIS WARNING:

The ESRB has identified medium-term vulnerabilities in the residential real estate sector in Liechtenstein 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 and increasing indebtedness of households against the absence of income-related borrower-based measures to mitigate further accumulation of risks related to the residential real estate sector.

Done at Frankfurt am Main, 2 December 2021.

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

(7) It should be noted, however, that such procyclical effects of a downturn in the financial cycle would be significantly weaker in Liechtenstein compared to other EEA countries, as domestic demand plays a relatively minor role in Liechtenstein's extremely small and open economy. Thus, even a marked increase of the households' savings rate would have negligible demand effects, limiting the impact on the broader economy.

(8) All banks in Liechtenstein apply the Standardised Approach for the calculation of own funds requirements.

(9) Recommendation of the European Systemic Risk Board of 31 October 2016 on closing real estate data gaps (ESRB/2016/14) (OJ C 31, 31.1.2017, p. 1).