



EUROPEAN CENTRAL BANK

EUROSYSTEM

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Macroprudential Policy Analysis for Real Estate Markets in the euro area

Oslo

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- 1 Principles of Macroprudential policy in response to systemic risks
- 2 Institutional background for ECB's Macroprudential policy role
- 3 Analysis of Real Estate Markets

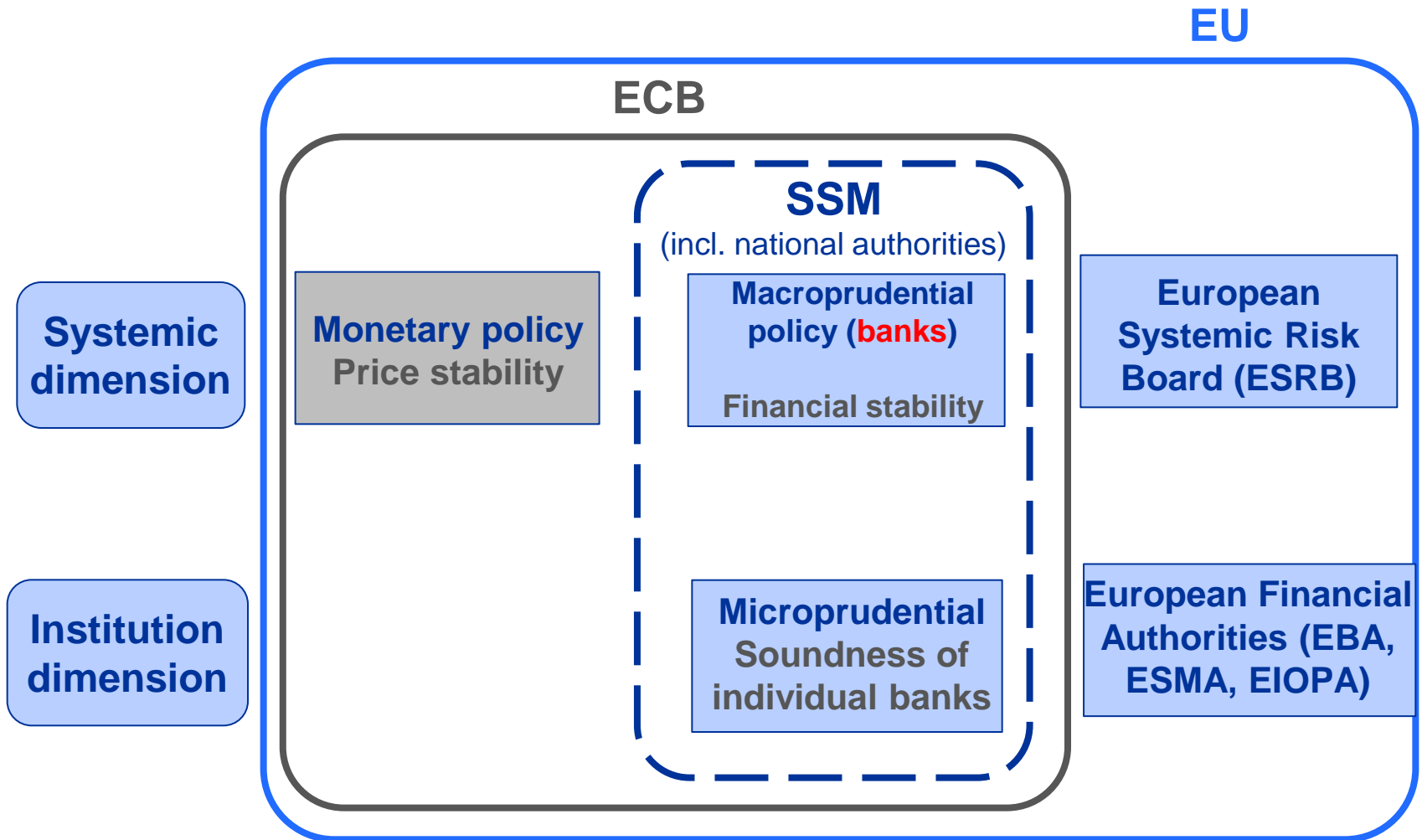
Vítor Constâncio, ECB Macroprudential policy and research conference, May 2017

1. Macroprudential policy should be pre-emptive and strongly counter-cyclical
2. The financial cycle is crucial for the rationale of macroprudential policy, as it justifies targeted policy intervention already early in the cycle
3. The **real estate component is of paramount importance in the financial cycle**, and borrower based instruments are essential to influence the demand for credit and raise household / bank resilience
4. Macroprudential policy is complementary to monetary policy as both policies share the goal of macro-financial stabilization through forward-looking dynamic macro-risk management
5. Macroprudential policy should reach beyond the banking sector and encompass market-based finance institutions and products

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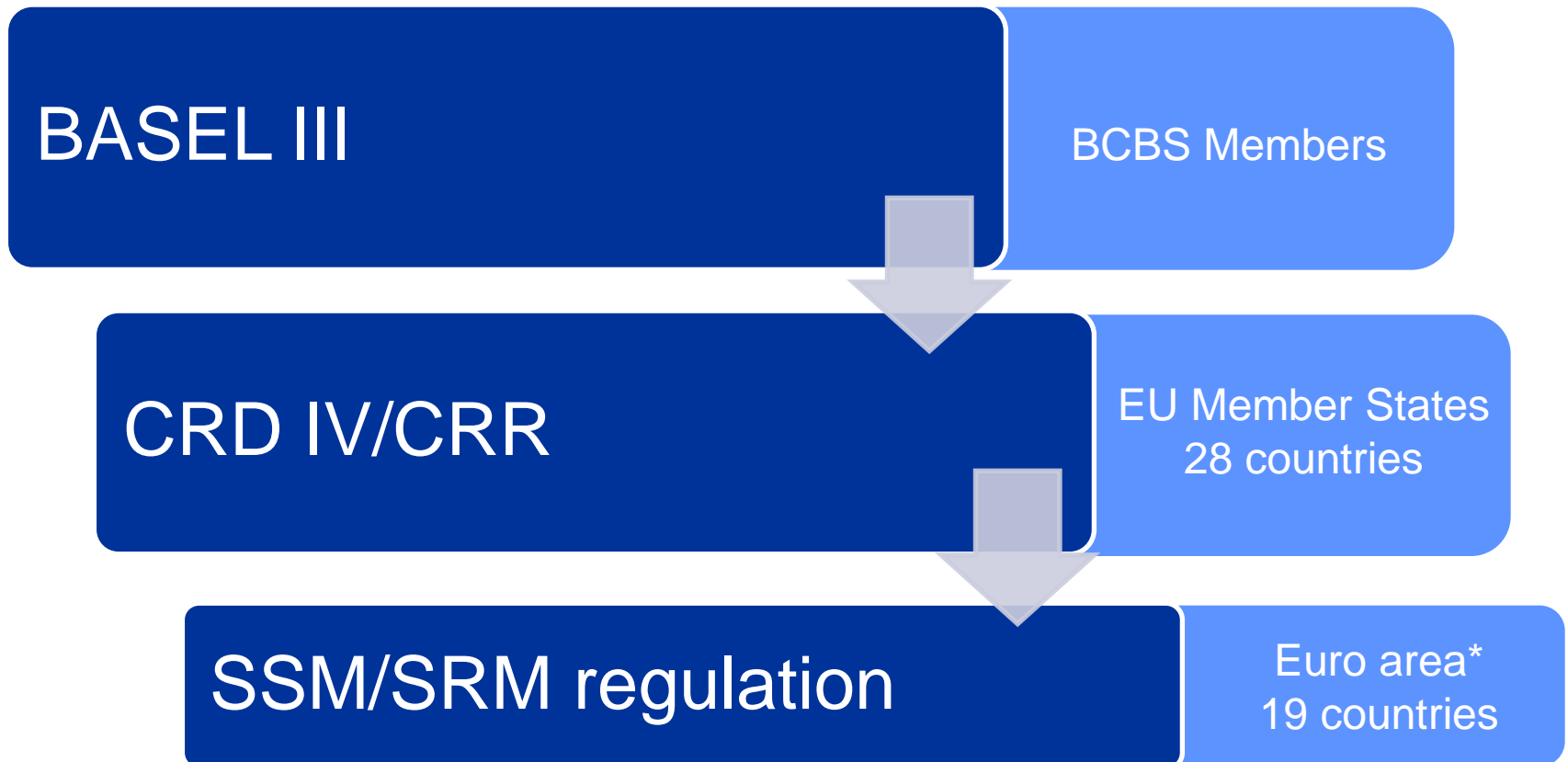
Institutional setting in the EU

Monetary and prudential policies at the ECB and in the EU



Source: ECB

SSM = Single Supervisory Mechanism



*and potentially countries in close cooperation

- With the entry into force of the SSM Regulation on 4 November 2014, the ECB was given macroprudential tools to tackle the emergence of possible systemic risks in the financial system.

- The ECB has two mandates in the field of macroprudential policy:
 - 1. To comment and object**

National designated authorities have to notify the ECB when they intend to implement or change a macroprudential measure. The ECB assesses the planned measures and can object to them. National authorities consider the ECB's comments before proceeding with the decision.

 - 2. To apply more stringent measures**

The ECB may, instead of the national designated authorities, apply higher requirements for capital buffers and apply more stringent measures aimed at addressing systemic or macroprudential risks.

Broad set of instruments with varying legal basis

	CRD IV tools	CRR tools	Other tools
Capital based measures	<ul style="list-style-type: none"> • Countercyclical capital buffer (CCyB) • Systemic risk buffer (SRB) • G-SII & O-SII capital buffer 	<ul style="list-style-type: none"> • Risk weights for selected exposures • Capital conservation buffer • Own funds level 	<ul style="list-style-type: none"> • Leverage ratio
Liquidity-based measures		<ul style="list-style-type: none"> • Liquidity requirements • Large exposure limits (incl. intra-financial sector) 	<ul style="list-style-type: none"> • Non-stable funding levy • LTD ratio caps
Borrower-based measures			<ul style="list-style-type: none"> • LTV ratio caps • LTI ratio caps • DSTI ratio caps • DTI ratio caps
Other measures		<ul style="list-style-type: none"> • Large exposure limits (incl. intra-financial sector) • Disclosure requirements 	<ul style="list-style-type: none"> • Margin and haircuts requirements
<p>Can be used by national authorities and the ECB (for SSM countries)</p>			<p>Can only be used by national authorities</p>

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- 3 **Analysis of Real Estate Markets**

1 Cyclical systemic risks

- Developments in cyclical systemic risks at the SSM area level
- Cyclical systemic risks in individual SSM countries
- Policy considerations

2 Real estate risks

- Residential Real Estate
- Policy considerations – residential real estate
- Commercial Real Estate risks
- Policy considerations – commercial real estate

3 Structural systemic risks related to the banking sector

- Risks stemming from banks' systemic footprints
- Risks stemming from interconnectedness, asset commonality and overlapping portfolios
- Risks stemming from specific forms of cross-border banking and exposures to external sources of macroeconomic volatility
- Policy considerations

4 Country-by-country overview

Housing markets crucial from the point of view of economic and financial stability

- Huge costs of housing bubble bursts (Claessens et al. 2008; Crowe et al. 2013)
- Recessions that coincide with a house price bust tend to be deeper and last longer than those that do not (Cerutti et al. 2015)

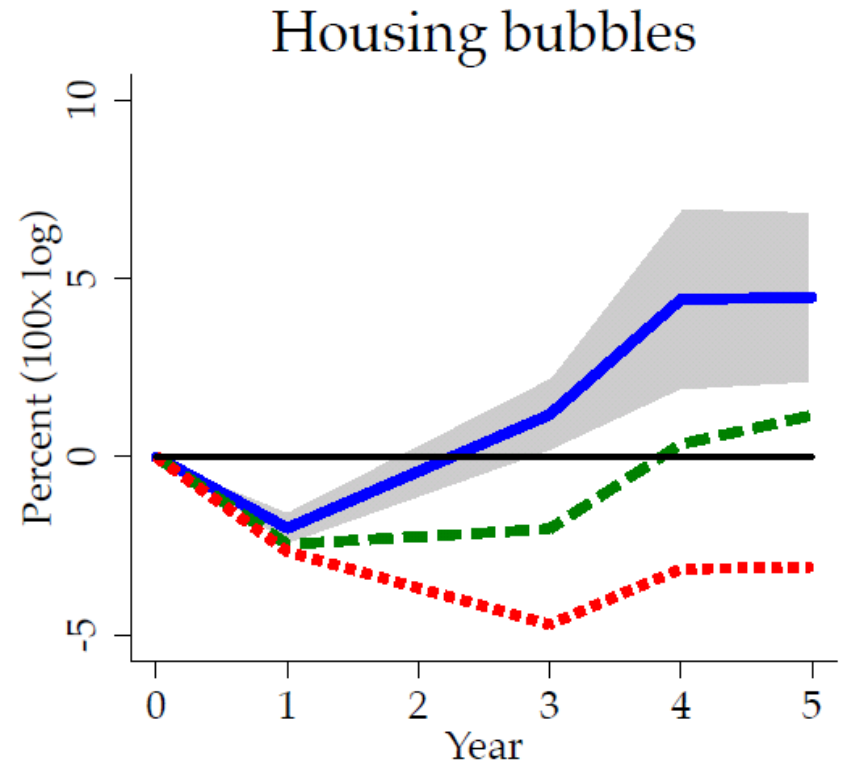
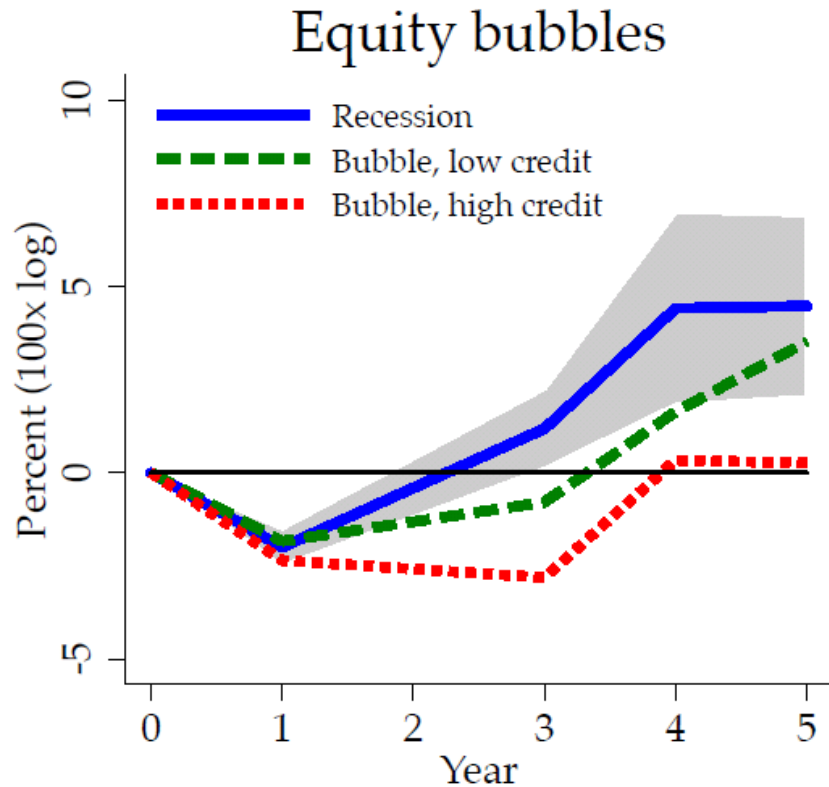
Key features of housing markets from a financial stability perspective

- Residential and commercial real estate purchases are largely financed by debt
 - Leverage ratios of home buyers are higher than in any other investment activity
 - A typical mortgage loan carries a loan-to-value ratio of 71 percent on average across a global sample of countries (Crowe et al. 2013)
- Potentially, large wealth effects stemming from shocks in housing markets
 - Real estate is the most important form of storage of wealth across countries (financial assets play a smaller role, especially in Europe)
- Real estate assets key form of collateral
 - Changes in real estate prices affect the supply of credit (financial accelerator mechanism)
- Spillovers to the rest of the economy via consumption, construction activity and credit

Type of bubbles and associated recessions

Equity and housing bubbles with and without credit:

⇒ Credit-financed house price bubbles are the most costly



Source: Jordà, Schularick, Taylor (2015)

Note: Year zero denotes the peak of GDP (start of the recession).

Risk assessment for real estate markets

- Consideration to the cyclical position of real estate markets
 - Macroprudential policy actions might differ depending on the cyclical position of markets
- Risk assessment based on key indicators across countries (horizontal approach) and integration of complementary country specific information (vertical approach)
- Outcome of the risk assessment:
 - Mapping of key vulnerabilities across countries

Policy assessment for residential and commercial Real estate markets

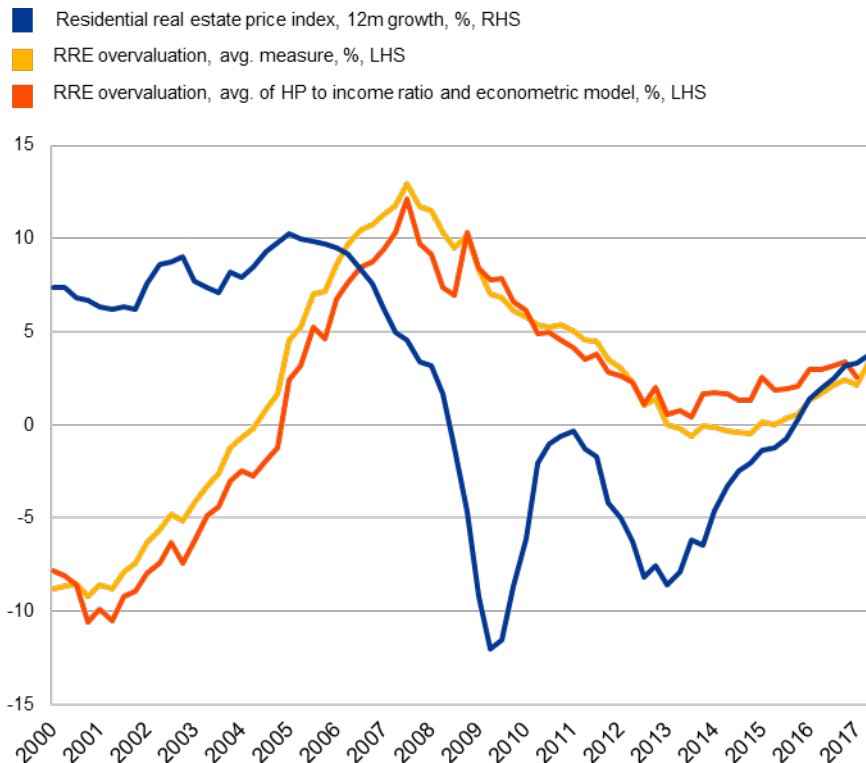
- Listing key policy priorities according to existing vulnerabilities
- Assess existing policies against identified policy priorities
 - Assess “appropriateness”: Are policies relevant to the identified risk?
 - Assess “sufficiency”: Are policies “commensurate” to the identified risk?

Residential real estate market – current developments

- Firm expansion according to price and lending dynamics...
- ...but both price and lending growth remain below pre-crisis levels, and household debt remained on a slightly decreasing path
- Valuations broadly in line with fundamentals

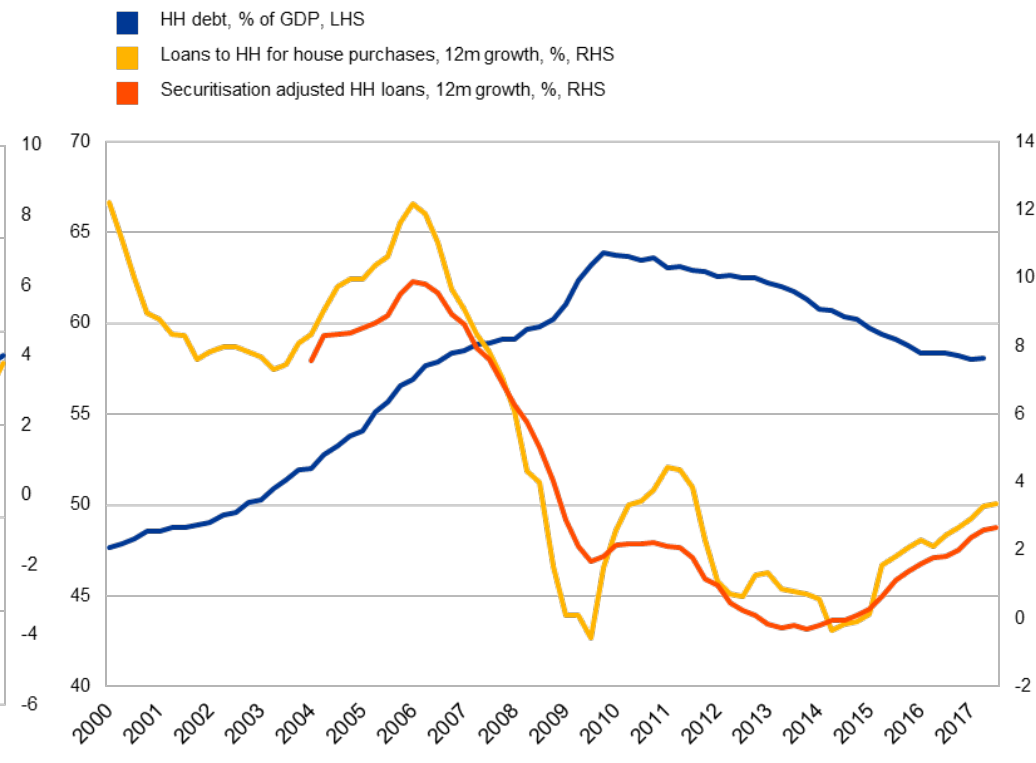
Residential real estate annual price growth and valuations for the euro area

Annual percentage change; percentage



Loans to households for house purchases, securitization adjusted loans and household debt to GDP

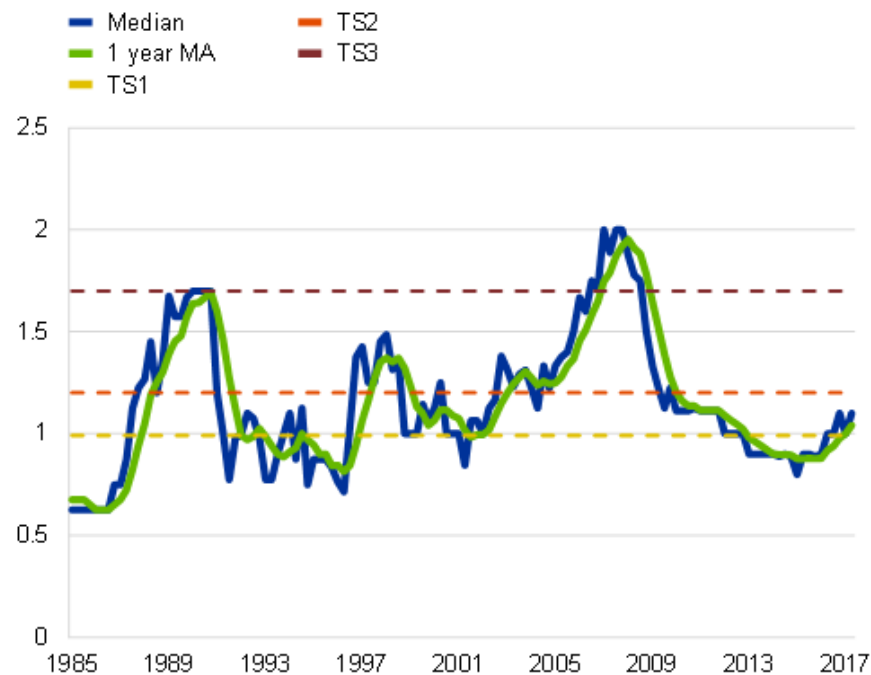
Percentage of GDP; annual percentage change



Residential real estate market – summary indicators of systemic risk in RRE markets

- **Composite measure of RRE systemic risk** (range between 0 and 3): it takes into account the strength of price dynamics, the level of price overvaluation, the dynamics and pricing of mortgage lending, and the strength of household balance sheets (debt ratios, financial assets and debt servicing ratios)
- **But situation heterogeneous across countries....**

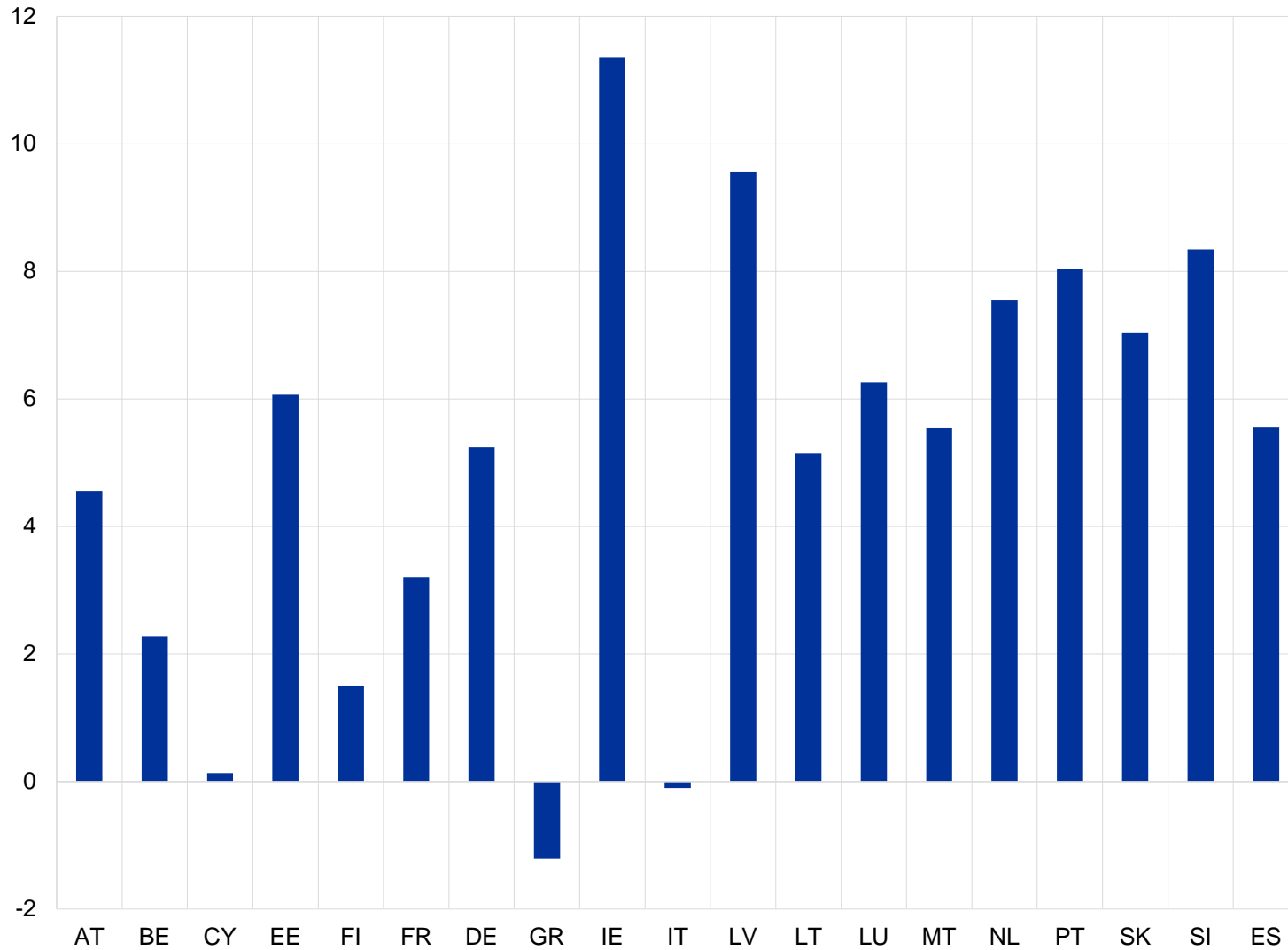
Low level of systemic risk in residential real estate markets (balanced expansion), although risk is gradually raising



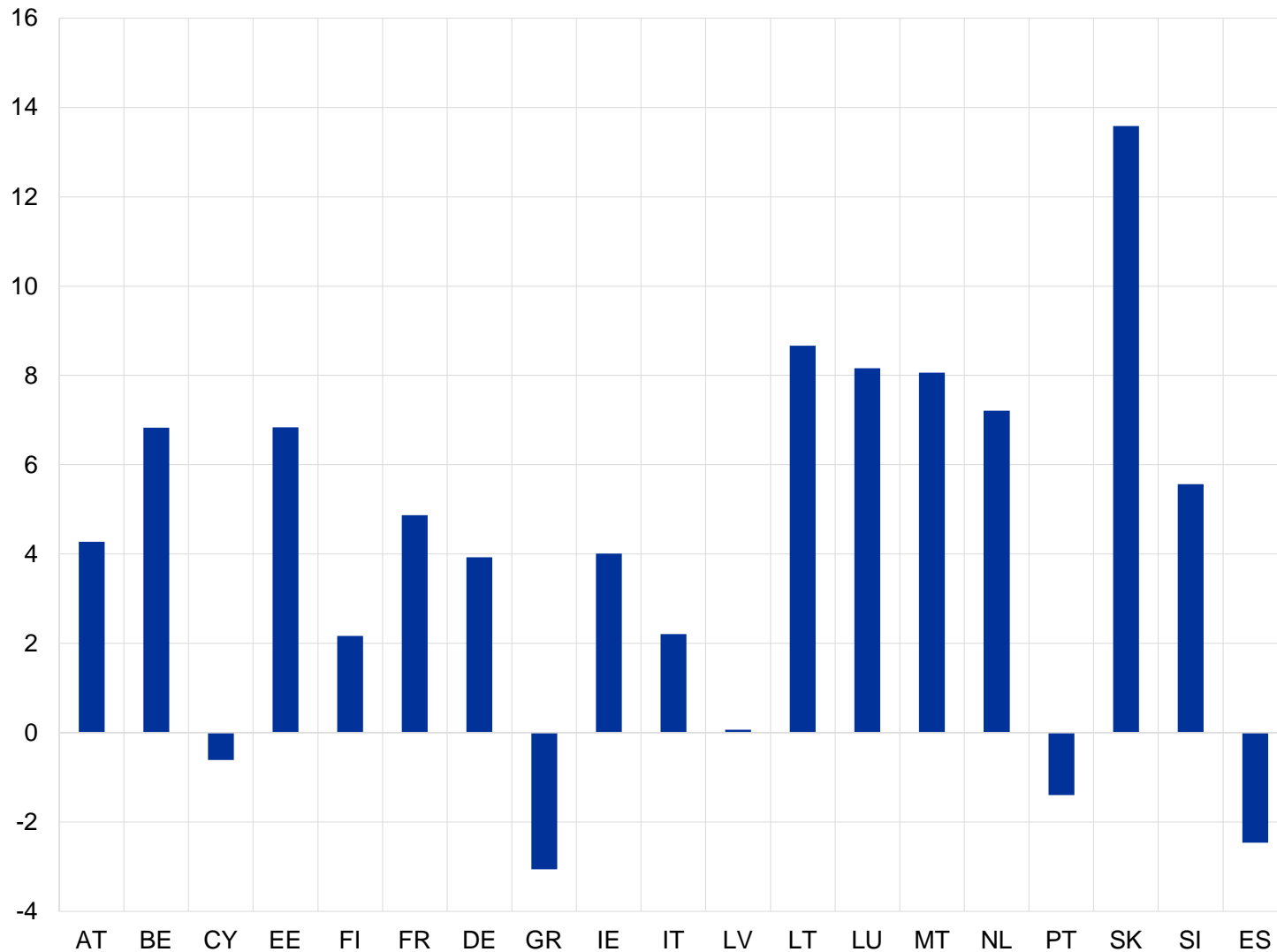
Sources: ECB and ECB calculations.

Notes: 1 year MA stands for 1 year moving average.

Annual growth of RRE prices, %



Annual lending growth for HP, %

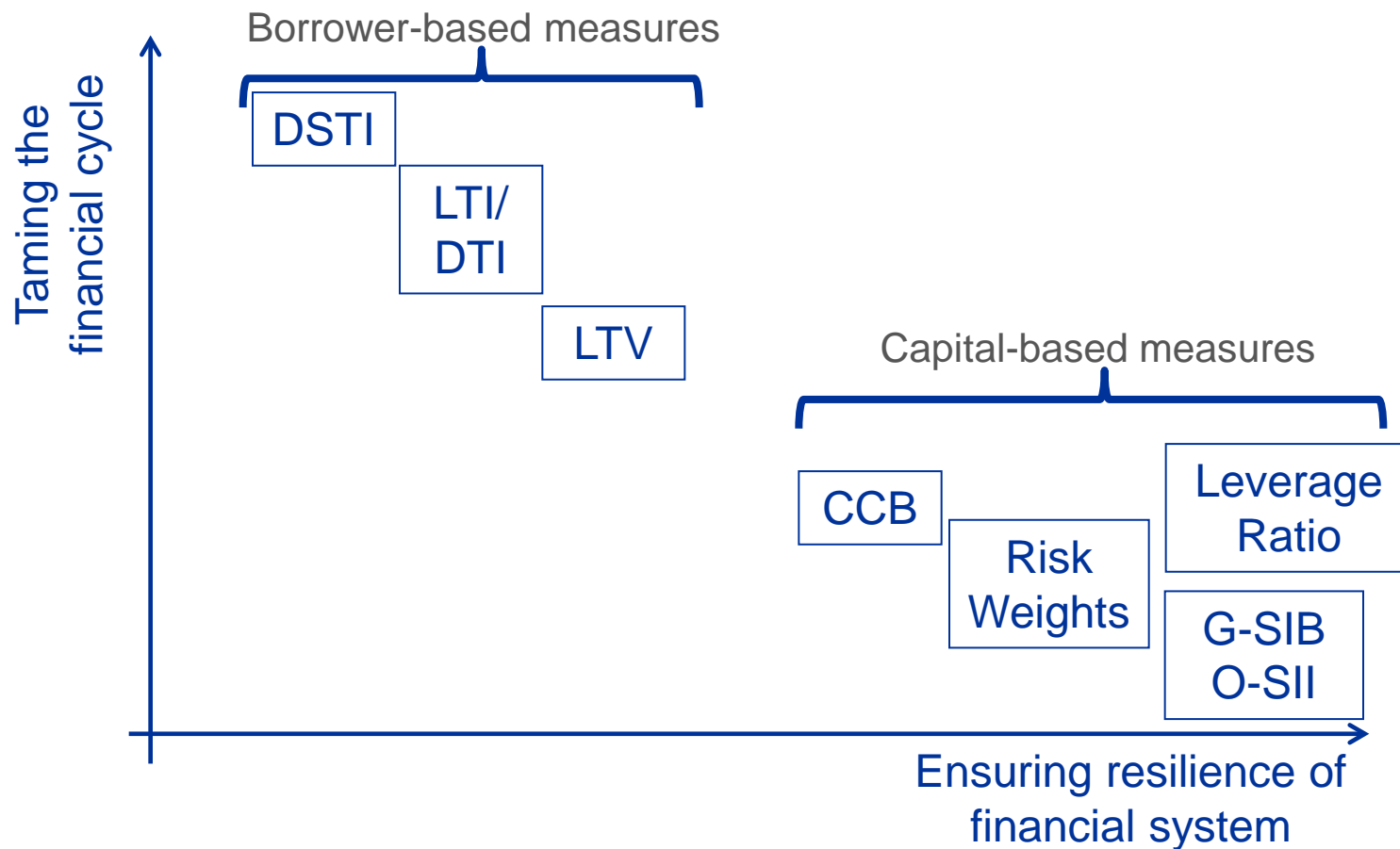


Risk warnings issued by the ESRB on 28 November 2016

➡ The ECB broadly shares the risk assessment for countries in the SSM

- **Austria:** High RRE prices and strong RRE price growth, moderate but growing pace of mortgage lending
- **Belgium:** relatively high and increasing of household indebtedness, against the backdrop of seemingly overvalued house prices and strong mortgage lending
- **Finland:** High and increasing household indebtedness, against the backdrop of RRE prices at high historical levels
- **Luxembourg:** High and robustly growing RRE prices, robust mortgage lending growth, high and increasing increasing household indebtedness
- **Netherlands:** persistently high household debt levels with low mortgage collateralisation

Relative strength of instruments



Borrower-based instruments in place across the SSM

LTV and DSTI/LTI sometimes activated or adjusted jointly or with maturity limit

		LTV limits (reduces LGD)	Income-based limits (reduces PD)	Max. maturity restriction (reduces long-term interest rate sensitivity)
SSM	Cyprus	70%, 80%	DSTI: 80% (65% in case of FX loans)	
	Estonia	85%, 90%	DSTI: 50%	30 years
	Finland	90%, 95%		
	Ireland	70%, 80%, 90%	New loans with LTI >3.5 cannot exceed 20% of portfolio	
	Latvia	90%, 95%	Internal DSTI limits	
	Lithuania	85%	DSTI: 40%-60% w/ interest rate sensitivity test at origination	30 years
	Netherlands	101% (1pp decline p.a. to 100% in 2018)	DSTI: 10 - 30%	30 years
	Slovakia	80%, 90%, 100%	80% (subject to 2 p.p. interest rate increase p.a. if interest rate is not fixed)	30 years (8 years for unsecured loans)
	Slovenia	80%	DSTI: 50 - 67%	

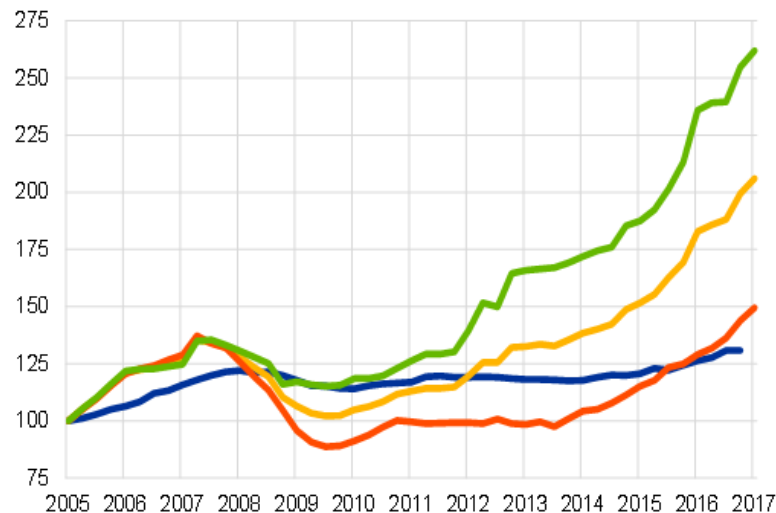
Current area of focus: Commercial Real Estate

- Relatively strong price dynamics in the prime segment
- Strong investment dynamics overall

CRE price developments driven by the prime and retail segments

Commercial property price indices in the SSM area

- commercial property (overall)
- prime commercial property (overall)
- prime commercial property (office)
- prime commercial property (retail)

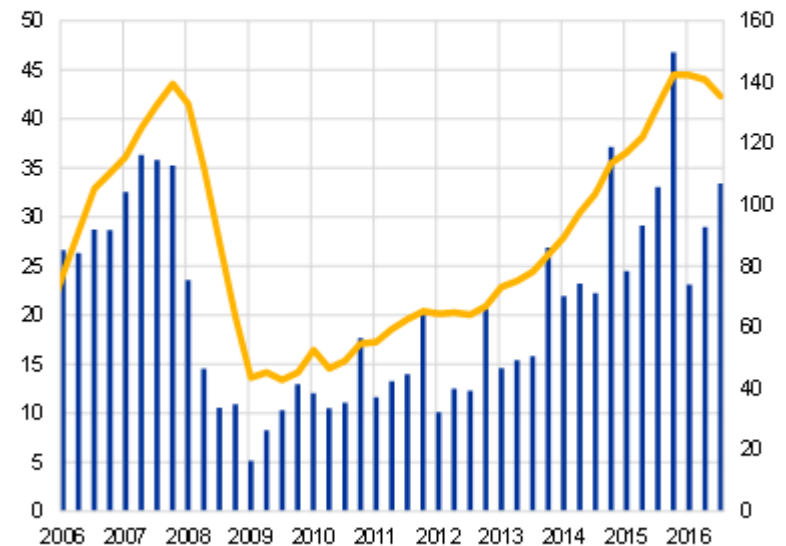


Sources: Jones Lang LaSalle and experimental ECB estimates based on MSCI and national data. Notes: Retail establishments include inter alia restaurants, shopping centres and hotels. The euro area aggregate comprises Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. The last observation is Q2 2017.

Strong rise in CRE investment activity since 2014

Commercial property investment transaction volumes in the SSM area

- investment volume (quarterly values; left-hand scale)
- investment volume (4-quarter moving sums; right-hand scale)

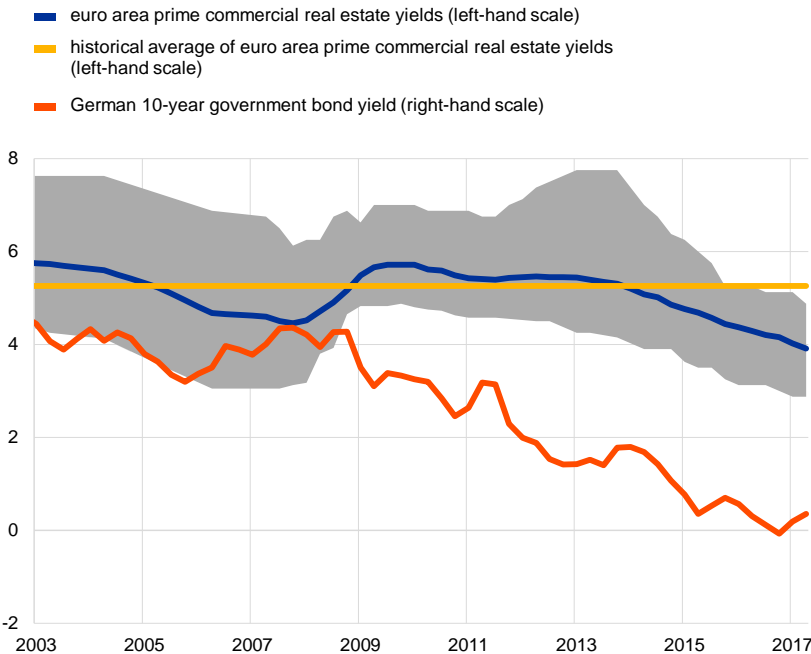


Sources: Cushman and Wakefield

Commercial real estate

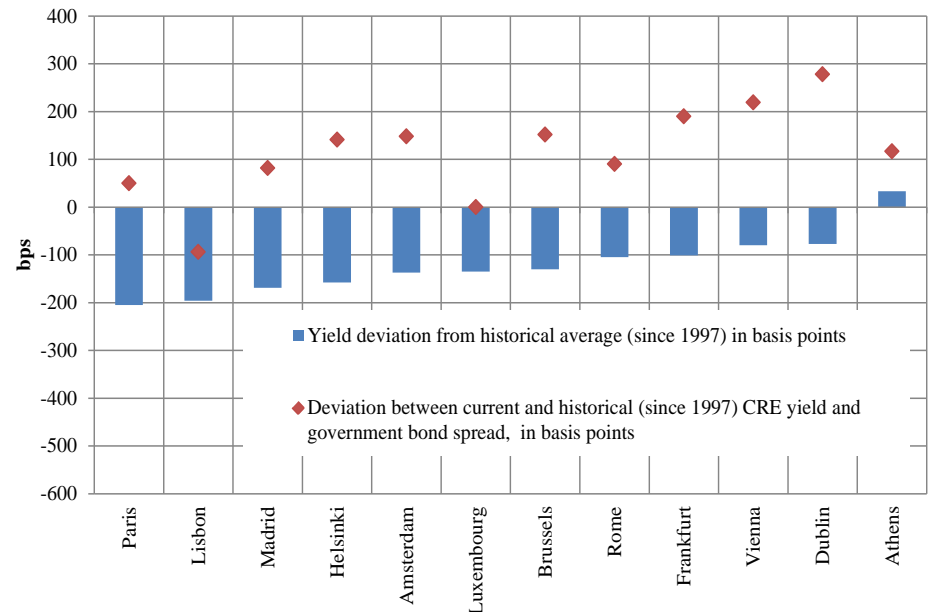
- Returns on prime commercial property have dropped to record lows amid continued signs of a search for yield.

EA prime CRE yields and the ten year German government bond yields (Q1 2003 – Q2 2017; percentages per annum)



Source: Bloomberg, Jones Lang Lasalle and ECB calculations.
 Note: The grey area represents the minimum-maximum range across euro area countries. The euro area countries covered are Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.

Prime CRE yields and spread vs. domestic government bond yield Basis point spread vs. historical average levels



Source: Jones Lang Lasalle and Bloomberg (last obs Jun 2017).

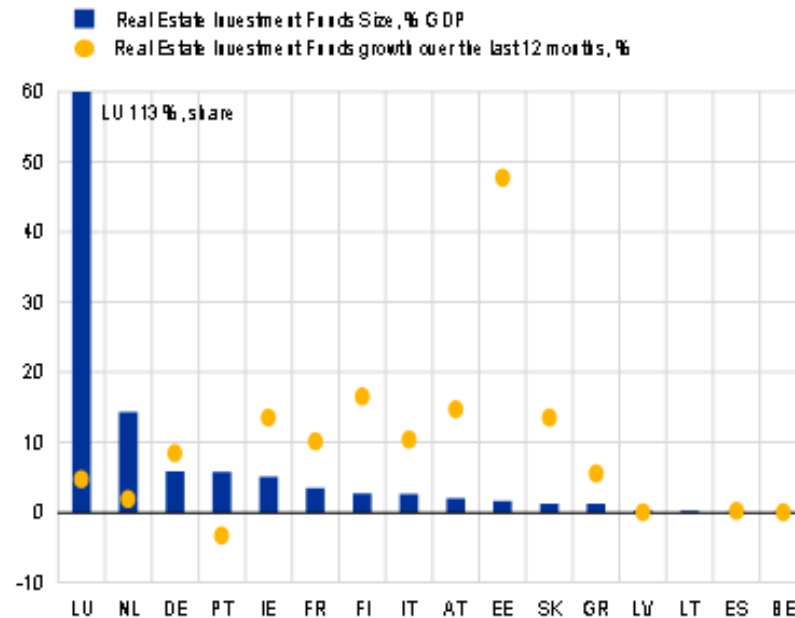
Current area of focus: Commercial Real Estate

- Changing investor's and funding base
 - Role of foreign investors
 - Role of market finance vs bank lending in CRE funding

Non-bank sources of funding are growing in importance

Real Estate Investment Funds (REIFs)

Assets of real estate investment funds in % GDP and annual growth



Sources: ECB Investment fund statistics. As of June 2017.

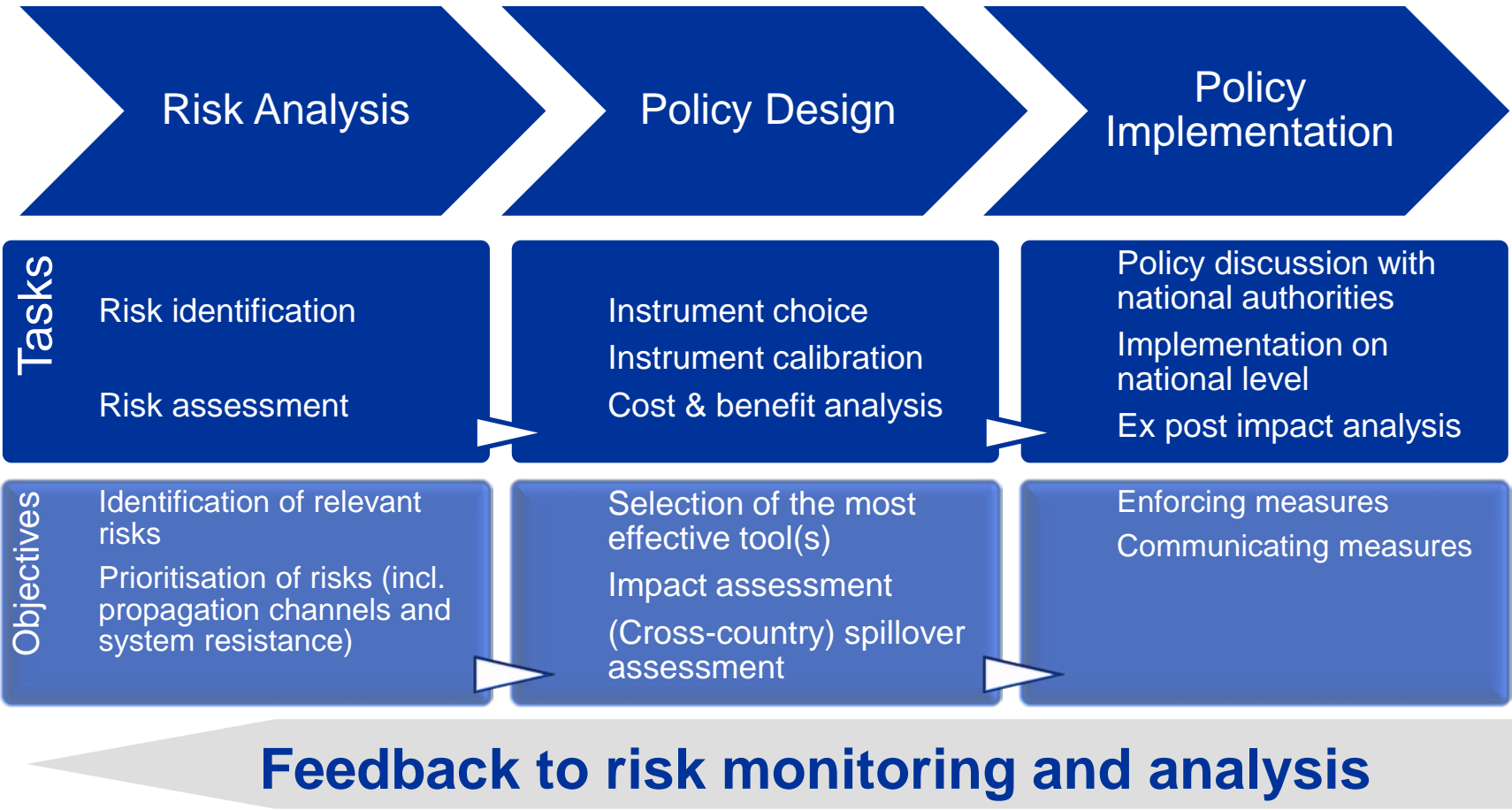
The last observation is Q2 2017. Notes: This database does not include REITs in all countries.

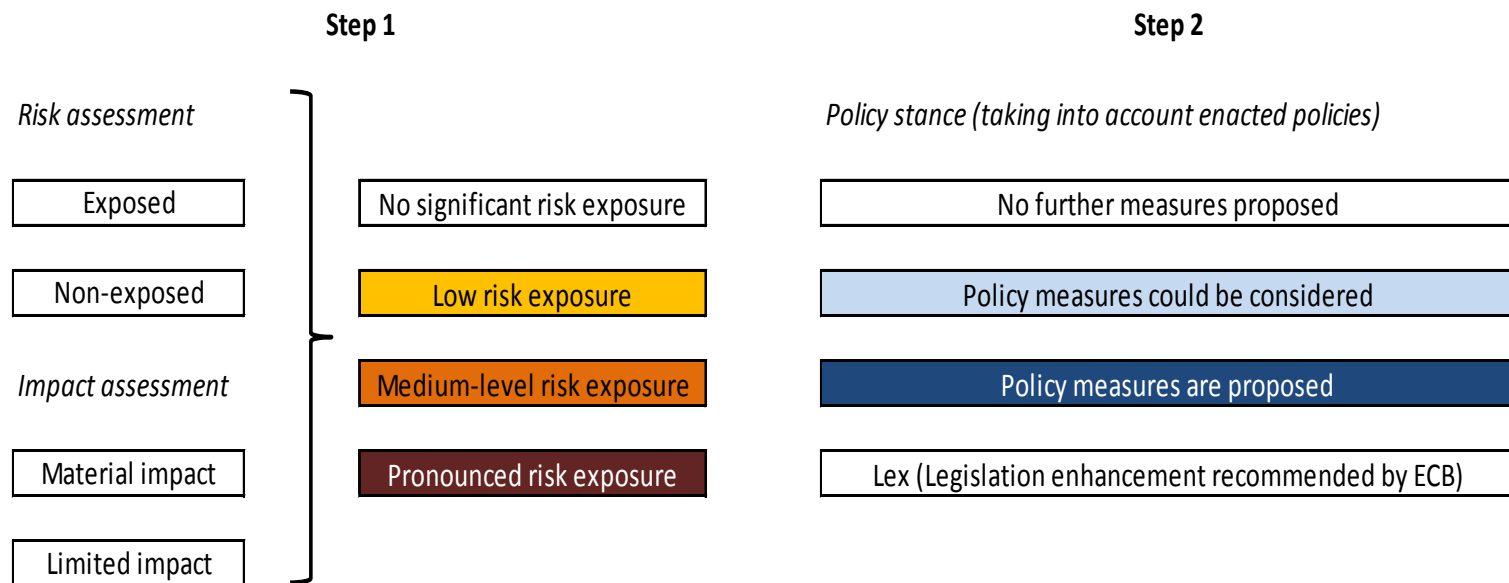
Key messages on euro area real estate developments:

- The cyclical expansion of residential real estate markets in the SSM area is on a firm path with prices and mortgage lending growing moderately and systemic risk is rising from low levels
- Heterogeneity across SSM countries
- Many SSM countries activated already policy responses but additional policy responses could be considered in some cases
- Commercial real estate markets have become very dynamic – again with significant cross-country heterogeneity
- Improving the availability of data on CRE will be crucial to better assess recent developments and associated policy needs.

Annex slide

The ECB macro-prudential policy framework





- **Step 1 – Risk Assessment:**
 - “Medium-risk” level indicates that there are vulnerabilities that could be addressed by macroprudential policies
 - “Pronounced-risk” level indicates that the vulnerabilities that could be addressed by macroprudential policies are widespread
- **Step 2 – Policy assessment:**
 - The macroprudential policy stance evaluation considers whether enacted policies are appropriate and sufficient to counteract systemic risk.