

European house prices: stretched affordability makes mortgages a luxury, dampens demand



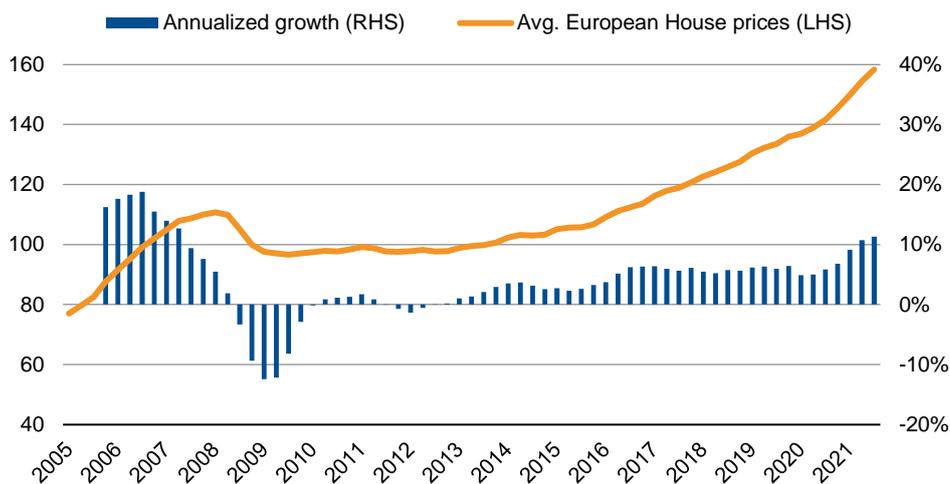
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The house price rally goes on, but recent rate increases are making mortgages a luxury. This is affecting demand and, by extension, house prices. Declining affordability among European households will likely halt the rally for the time being.

We do not expect a sudden or sharp decline in nominal house prices, however, as inflation in building materials prices will keep them buoyant. But by the same token, it will put additional pressure on top of a rising interest burden. Demand and real house prices are expected to suffer.

Average quarterly growth in European house prices (including the UK, Norway and Switzerland) stood at 2.5% in the last quarter of 2021. This is slightly down compared to Q2 and Q3, when growth hit the 3% mark. However, despite the slightly lower quarter-on-quarter growth, annual average house price increases hit 11.3%. The last time, annual growth in Europe was in double digits was back in 2006 but they found a sudden reversion in the guise of the global financial crisis.

Figure 1: European house prices



Source: Eurostat, Scope Ratings

The situation today is different. We do not expect a slump as seen back in 2008. Undersupply of housing is prevailing in many European countries, particular in metropolitan areas. Oversupply driven by speculation, which contributed most to the severe slump in house prices and most pronounced in Ireland and the European periphery, is not visible today.

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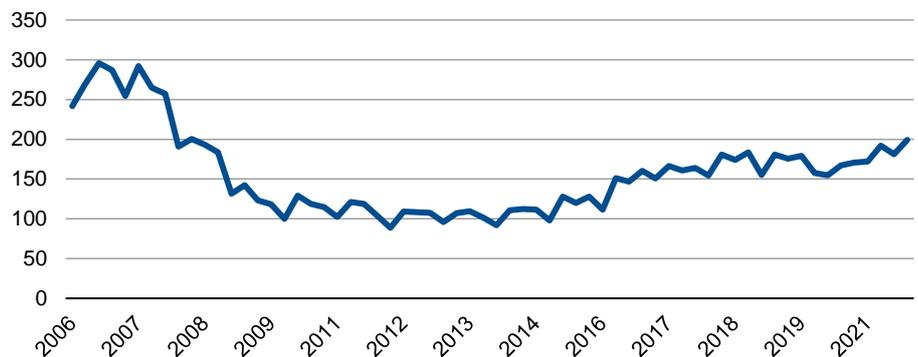
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Figure 2: European building activity (indexed)



Source: Eurostat, Scope Ratings

Ongoing high demand for housing

... but high leverage, stretched affordability constrain new house purchase

As such, it comes as no surprise that banks reported a continued increase in demand for mortgages, according to the ECB lending study from February 2022. Ultra-low interest rates at the time of the survey still made mortgages a giveaway, fostering demand from households and real estate investors. Also, the pandemic continues to fuel the desire to move into more spacious homes, adding to demand to own real estate.

Households today face the highest debt to income and leverage seen in the last decade (see [European house prices reaching their climax?](#)). Affordability is increasingly also becoming stretched.

European house prices have grown more than 5% per annum for eight consecutive years, while average wage growth has only hobbled along at around 2%. Stretched affordability is increasingly becoming a factor for banks underwriting mortgages, as highly geared households are failing affordability tests – particularly when including potential rate hikes.

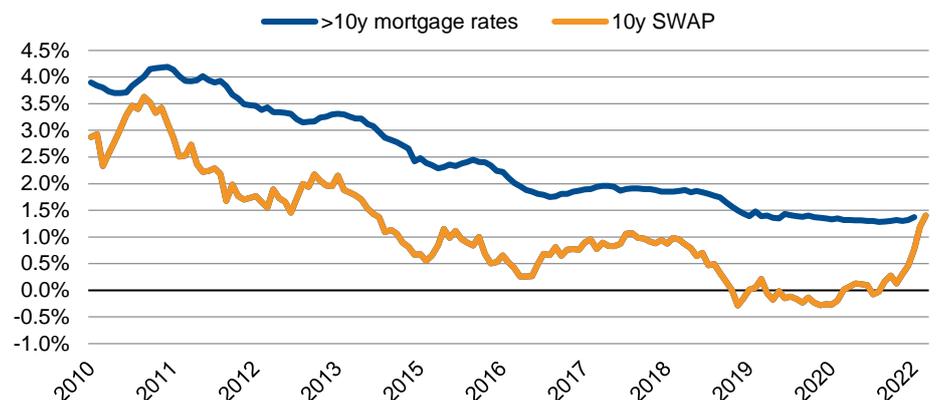
Will higher interest rates moderate house-price growth?

The mix of rising inflation and the impact of the war in Ukraine has already prompted higher European mortgage rates in March and April this year, mainly in fixed-rate markets. For instance, the rate on a 10-year mortgage in Germany has already doubled to about 2%, a level not seen since 2015. More is to come.

Ten-year euro swap rates have increased sharply and reached 1.40% on 11 April 2022. With an average lending margin of 1.35% on top of the bank's pricing base for 10-year mortgages, mortgage rates will likely reach 2.75% within weeks.

On average 2.75% 10-year mortgages expected within next weeks

Figure 3: European fixed rates* (10-years plus) vs EUR 10y swap



*until end of February 2022

Source: ECB, Bloomberg, Scope Ratings

Fixed rate mortgage with significant rise in costs...

A EUR350.000 10-year fixed-rate mortgage taken out six months ago and assuming a 2% annual amortisation required a monthly payment of around EUR 1,000. If today's 10-year swap is fully reflected in lending rates, this would lead to a 40% increase to EUR 1,400 per month. On top of that, borrowers will also have to pay for the increased cost of living.

Borrowers who have not yet locked into low fixed rates will see their financing packages for home purchases to become challenged. They will either have to postpone their home purchases or, if they are lured by lower floating rates, they will become exposed to rate increases at the next re-fixing.

Banks may be hesitant to directly pass through long-term refinancing rates, as household mortgages remain attractive and highly competitive at the same time. But earnings pressures keep pushing. According to the ECB lending survey, risk tolerance and cost of funds had a slight net tightening effect on mortgages, and we expect this to have tightened even further in first quarter 2022 data.

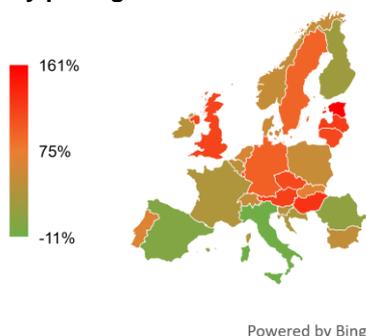
... for now, floating rate markets on the inside track...

For now, short-term floating-rate mortgages, which still account for the majority of European mortgages, look appealing given the European Central Bank's hesitation to raise rates. But this will change in late 2022 or early 2023. Not even the ECB can push back against general inflation hikes.

... but ECB cannot push back forever

To recap, a central bank's principal objective is maintaining price stability, and as according to the ECB this represents the most important contribution to monetary policy. It's hard to argue in favour of remaining hesitant to move on rates with inflation way above 5%—inflation that is not a temporary phenomenon driven by "special" effects from the pandemic or Russia's invasion of Ukraine.

Figure 4: heat map of European 12y price growth



While rising interest rates and general inflation will be a European phenomenon, any correction within European real estate markets may be more country-specific. This is because some markets have experienced an exceptional rally since 2010 while others have remained relatively steady. For instance, house prices in the UK, Germany, Austria and Sweden have doubled but prices in Spain and Italy have remained stable.

We see stressed interest rates as a necessary part of the underwriting toolkit and welcome borrower-based macroprudential measures as a way to avoid exuberance (see [Hesitation by policy makers introduces financial stability risk in Germany](#)).



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