SCOPE Scope Ratings

European housing market

Systemic risk remains high

Analyst

Mathias Pleissner

+49 69 6677389-39

m.pleissner@scoperatings.com

Team leader

Karlo Fuchs

k.fuchs@scoperatings.com

Media

Keith Mullin

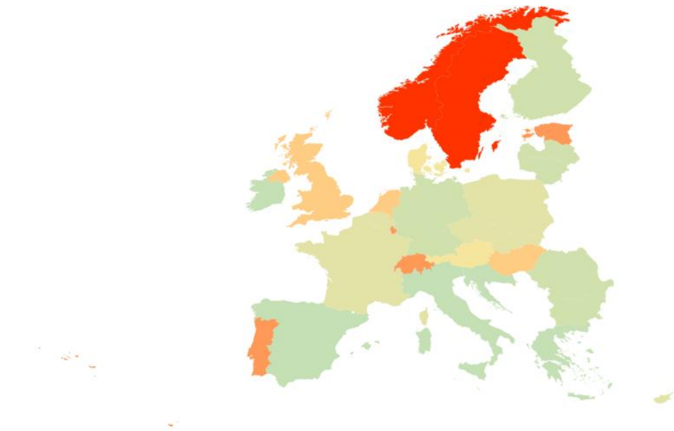
k.mullin@scopegroup.com

Weak economic fundamentals, high leverage and high interest rates have stretched the affordability of housing and have the potential to unleash systemic risk. Macroprudential measures can help cushion risks but these differ across Europe. Germany might finally see borrower-based measures but they will need to be carefully calibrated to avoid further curbing housing supply.

Despite progress towards harmonisation across Europe, it is astonishing how different mortgage markets are. We have identified countries we believe have a higher propensity for systemic risk arising from the characteristics of their residential mortgage markets.

Our updated study on European mortgage markets found that systemic risk has remained relatively stable. The same countries are still exposed to a combination of rate-sensitive loan origination, high indebtedness and only moderate value corrections, in particular Norway and Sweden. However, Switzerland, Portugal and Luxembourg are also exposed to higher risks from their mortgage-market characteristics. Above-average house price corrections in recent years have relaxed the picture for Denmark, Finland and Germany.

Figure 1: Mortgage market-driven systemic risk



Source: eurostat, Scope Rating

What Northern European consumers have in their favour is that despite their debt leverage, they are typically also among the richest in Europe. Danish and Dutch households are the wealthiest countries globally measured by net worth in relation to net disposable income. Sweden ranks Top 7. Norway is way behind but benefits from a wealth fund that in theory accounts for around EUR 250.000 per citizen. While this wealth is credit positive, it is at the same time not liquid enough to buffer systemic shocks that can have immediate impacts on households. Regulators are right to manage sector risk through borrower-based macroprudential measures.

Real estate encumbrance highest in the Nordics

Systemic risk factors highlight intrinsic weaknesses driven by the structure of a country's mortgage market. Where a high share of households owns a property with a mortgage attached, any systemic change affecting those mortgages may have an exaggerated effect on that's country's society (see **Figure 2**).

Assessing each mortgage market's exposure to real estate encumbrance in general, Sweden, Netherlands and Norway come out as having high risk. All have relatively high owner-occupied property markets and at least 75% of homeowners have mortgages. In contrast, many Eastern European countries have a very high share of owner-occupied property free of mortgages.

Germany and Austria will be less systemically affected by mortgage turmoil as they have low owner occupancy rates and below average debt leverage. Risk can be amplified, however, in markets where borrowers are highly leveraged but where interest resets on mortgages are short-dated, as rate increases will by definition stretch affordability.

Encumbrance, leverage and floating mortgages – the hotspots

To gain additional insights, we analysed household leverage by comparing average debt to income (DTI) to exposure to floating-rate mortgages, using the ratio of DTI to the five-year average of new mortgages with an interest reset below one year (see **Figure 3**). Norway and Sweden again stand out as mortgage markets with the highest potential to be affected by systemic risk as affordability looks stretched.

Figure 1: Households real estate exposure

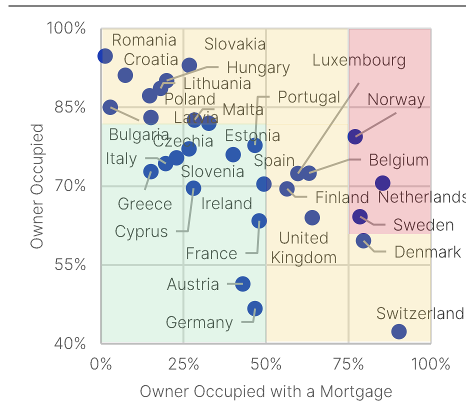
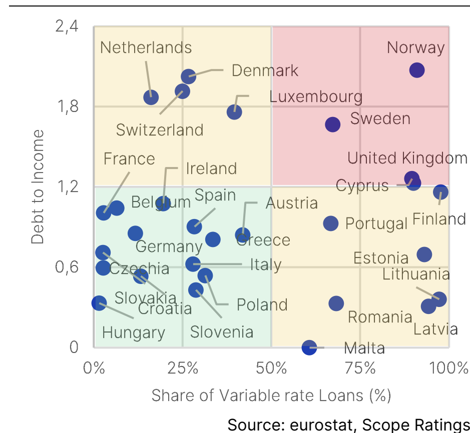


Figure 2: Households leverage / interest exposure



Source: eurostat, Scope Ratings

Denmark, Switzerland and the Netherlands likewise have high DTI ratios (above 1.8x) but their exposure to floating-rate mortgages is significantly smaller. This will ultimately give households more time to adapt to higher interest rates.

Beyond rate rises, systemic risk affecting households is also driven by house-price developments. Where house prices are elevated, households benefit from a high wealth effect and low leverage. But the opposite occurs if house prices fall: wealth decreases and leverage and refinancing risks increase. As such, households are most exposed where house prices are overvalued, and bubble risk emerges.

There is no simple way to assess a market's degree of over-valuation risk as it depends on many individual systemic and idiosyncratic factors. However, for developed countries long-term house-price growth should not significantly exceed that of the economy.

Most European house prices weather the storm

European house prices are holding steady despite some significant shocks from rising interest rates and macroeconomic tension. But performance across countries is diverse (see **Figure 4**). Since the beginning of the rate rise in the first quarter in 2022, prices have fallen in only six countries of the European Union plus Switzerland and the UK. Luxembourg, followed by Germany, Finland, Sweden and Denmark are the only countries to have seen house price corrections. Most of those countries have been identified as exposed to systemic risks.

Figure 4: Cumulative growth since Q1 2022

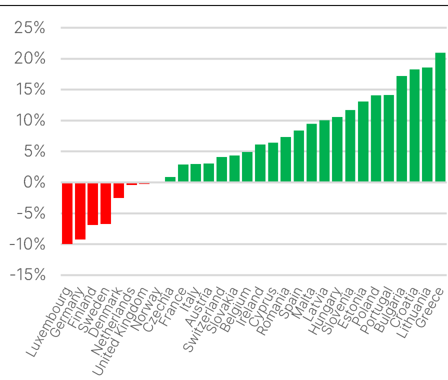
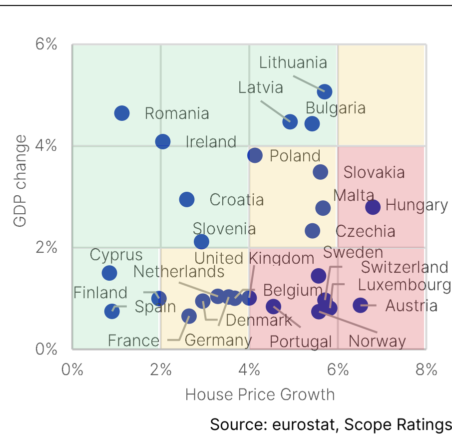


Figure 5: House-price sustainability



Source: eurostat, Scope Ratings

Further room for European house-price corrections

We do not think that developments in European mortgage markets have hit a trough. Prices are expected to continue falling moderately, in particular where prices are seen as unsustainable (see **Figure 5**). This is the case for Austria, Norway and Luxembourg, where house price growth for over a decade has been seven times average annual real GDP growth over the same period. For Switzerland and Portugal, the multiple is five times; for France and Sweden four times.

Combining the three risk factors, systemic risks are highest in the Nordic countries, which stand out in terms of household exposure to mortgage lending, borrower leverage, share of variable-rate loans and elevated house prices (see **Figure 1**). Norway and Sweden rank first followed by Switzerland, Luxembourg and Portugal, which have above-average vulnerability. Compared to our analysis a year ago, systemic risk has remained relatively stable but some above-average house price corrections have relaxed the picture for Denmark, Finland, and Germany.

The factors discussed above highlight some intrinsic weaknesses driven by the structure of mortgage markets. To identify whether contagion risk is high, we also assessed mitigating factors such as demographic changes (including immigration) and whether low building activity can sustain housing shortages thereby sustaining or even pushing up house prices. The political environment can also be supportive such as in France, where mortgage rates can only be increased gradually as increases are capped based on the lending rates as of the previous earlier. This removes pressure on households.

Interest rates are the elephant in the room. Compared to last year, risks for markets heavily exposed to floating-rate loans have relaxed as interest-rate expectations are trending down. While rising interest rates have stretched affordability, non-performing loans are still relatively low for European banks and have not yet indicated massive credit deterioration as we saw in 2009 for instance. See European Banking Outlook: sound fundamentals support credit profiles but profitability will decline.

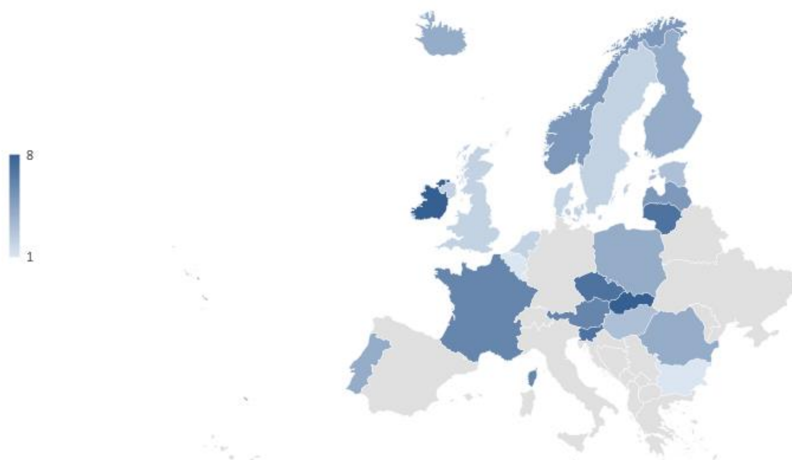
Regulatory toolkits help mitigate systemic risks

Additional risk mitigation comes from regulatory action. Exuberance in European residential real estate has been a key theme for national regulators, macroprudential authorities and the supervisory side of the ECB in recent years. The fact that regulators have a well-stocked macroprudential toolkit in all the countries where we identified high systemic risk is reassuring (see **Figure 6**). Regulators have activated such measures for some time now.

A study released in December 2023 by the Committee on the Global Financial System under the sponsorship of BIS (see here) concluded that macroprudential measures, in particular borrower-based measures, can mitigate potential stability risks arising from housing market developments; some better than others. Loan-to-value ratios are less effective in targeting borrower resilience though they do help to strengthen lenders' resilience. Tools based on borrowers' income, like debt-service-to-income ratios, have been shown to be a more effective way of targeting borrower resilience. As of end 2023, loan-to-value based measures in Europe accounted for 32%, income-based measures for 31% followed by 25% for amortisation or maximum maturity. No direct measures are in place around interest-rate fixing, though.

Nordic and CEE countries have been at the forefront of limiting the origination of risky mortgages given strong house-price appreciation and the typically floating-rate nature of mortgages.

Figure 6: Number of active borrower-based macroprudential measures in Europe



Source: ESRB, Scope Ratings

Measures are not evenly distributed across Europe, however. Also, not all countries we believe will be susceptible to corrections have implemented the same measures. A common thread is they only impact new origination. It will take time to insulate back books. Western European regulators have been less active and late. Most prominently, German authorities have long chosen not to opt for targeted borrower-based measures but for general bank-focused measures instead.

Germany finally joins the club?

This may change soon as plans are on the table for the German government to introduce borrower-based, in particular income-based, macroprudential measures as early as the first half of 2024. With hindsight, this comes as no surprise as they were part of the fine print in the "Ampels" coalition agreement.

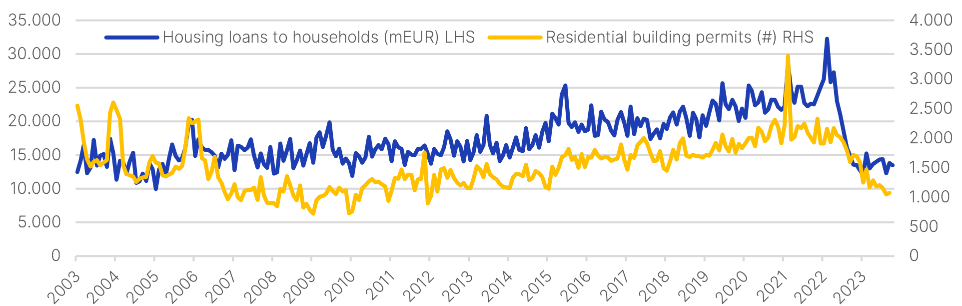
We strongly believe that well calibrated borrower-based measures are the most effective way to avoid exuberance in mortgage markets and are credit positive from a financial stability point of view. They are long overdue but at the same time will be difficult to push through politically and arguably the timing is not perfect.

Headwinds are increasing from a lot of stakeholders. Banks have voiced strong concerns as they fear the impact on new mortgage lending and they are already burdened by the increase of the systemic risk buffer. Banks generally believe that the idiosyncratic structure of the German mortgage market is a stabilising force. In particular as the regulator can already set maximum loan-to-value thresholds or loan terms.

At the same time, there is a significant shortage of housing and in particular affordable housing, which despite political efforts has only gotten worse. According to a study by the Pestel-Institute, the housing shortage in Germany stands at 800,000 apartments, an increase of 100,000 compared to a year ago. The shortage of affordable housing is even higher.

German households are suffering from stressed affordability due to high interest rates. Income-based measures might be the final nail in the coffin for buyers who see their mortgage applications rejected. Building activity and new mortgage lending both contracted significantly in 2023. For many banks it almost halved (see **Figure 7**).

Figure 7: German household mortgages vs. building permits (monthly)



Source: destatis, Deutsche Bundesbank, Scope Ratings

But constraining factors for the German residential mortgage market have peaked. House-price declines show signs of bottoming out. Coupled with a decrease in long-term interest rates a year ago (10-year mortgages are down from above 4% to about 3%) the German property market is set for a revival. While the timing of macroprudential measures might be challenged by market participants, their effectiveness will only become clear if they come prior to a cyclical peak as they will only impact new lending and not the back book.

As seen in Austria, it is not about the measures as such but also about how they are calibrated. Well-run banks already apply even more conservative criteria in their underwriting. But if thresholds are consensus based, including the ability to override them, macroprudential measures will only impact banks with loose lending criteria or borrowers who are stretched even in good times. They will avoid pockets of instability that could create contagion through the whole financial system.

Related research

Covered Bonds outlook

"Covered Bond Outlook: Back to a credit-driven buyer's market", published 22 Jan 2024 available here

Bank outlooks

"European Banking Outlook: sound fundamentals support credit profiles but profitability will decline", published 15 Jan 2024 available here

"French banks 2024 outlook: resilient credit profiles underpinned by recovering retail margins", published 11 Jan 2024 available here

"Spanish banks 2024 outlook: high earnings, clean balance sheets, adequate capital", published 19 Dec 2023 available here

Sovereign Outlooks

"Sovereign Outlook: Soft landing, turn of the global rate cycle balance fiscal and geopolitical risks", published 15 Dec 2023 available here

"Supranational Outlook 2024: strong fundamentals as institutions seek to expand lending capacity", published 14 Dec 2023 available here

"CEE Sovereign Outlook: Recovering growth, diverging fiscal paths, and persistent geopolitical risks", published 17 Jan 2024 available here

Related Outlooks

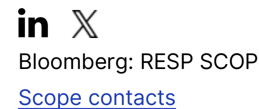
"European CRE/CMBS outlook: stormy seas to continue", published 8 Jan 2024 available here

"Europe faces further rise in corporate defaults: insolvencies to plateau only late 2024, early 2025", published 13 October 2023 available here

Scope Ratings GmbH

Lennéstraße 5
D-10785 Berlin
scoperatings.com

Phone: +49 30 27891-0
Fax: +49 30 27891-100
info@scoperatings.com


Bloomberg: RESP SCOP
Scope contacts

Disclaimer

© 2024 Scope SE & Co. KGaA and all its subsidiaries including Scope Ratings GmbH, Scope Ratings UK Limited, Scope Fund Analysis GmbH, and Scope ESG Analysis GmbH (collectively, Scope). All rights reserved. The information and data supporting Scope's ratings, rating reports, rating opinions and related research and credit opinions originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data. Scope's ratings, rating reports, rating opinions, or related research and credit opinions are provided 'as is' without any representation or warranty of any kind. In no circumstance shall Scope or its directors, officers, employees and other representatives be liable to any party for any direct, indirect, incidental or other damages, expenses of any kind, or losses arising from any use of Scope's ratings, rating reports, rating opinions, related research or credit opinions. Ratings and other related credit opinions issued by Scope are, and have to be viewed by any party as, opinions on relative credit risk and not a statement of fact or recommendation to purchase, hold or sell securities. Past performance does not necessarily predict future results. Any report issued by Scope is not a prospectus or similar document related to a debt security or issuing entity. Scope issues credit ratings and related research and opinions with the understanding and expectation that parties using them will assess independently the suitability of each security for investment or transaction purposes. Scope's credit ratings address relative credit risk, they do not address other risks such as market, liquidity, legal, or volatility. The information and data included herein is protected by copyright and other laws. To reproduce, transmit, transfer, disseminate, translate, resell, or store for subsequent use for any such purpose the information and data contained herein, contact Scope Ratings GmbH at Lennéstraße 5, D-10785 Berlin.