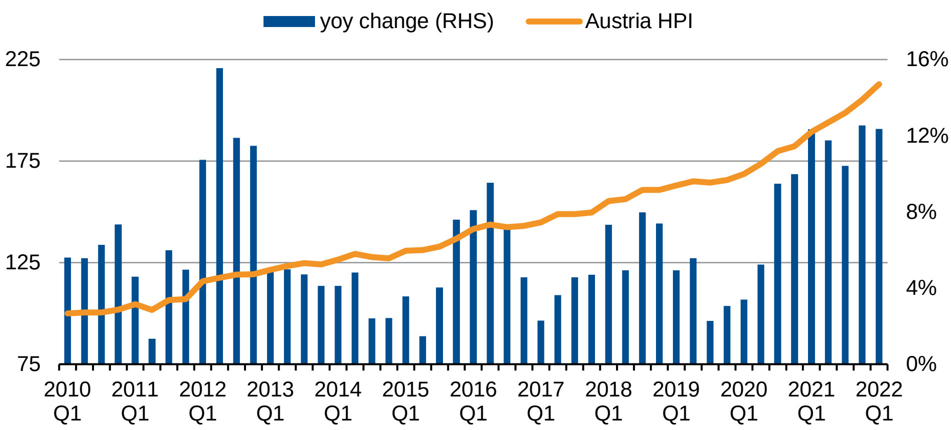
Austrian lending limits will not ensure financial stability if interest rate-risk is excluded

Austria's Financial Market Authority (FMA) proposed lending limits for mortgages, to take effect on 1 July 2022. The macroprudential measures address the risks built up in the housing market and provide flexibility to finance growing demand for home ownership. However, the exemptions in the proposal are too generous and do not really tackle the emerging risk of higher interest rates. Legislative adjustments are needed.

Headline political risk, rising living costs and the looming monetary policy turnaround failed to stop Austria's house-price boom. In the first quarter of 2022, house prices appreciated by 12.4% on an annualised basis. House-price growth is outpacing economic fundamentals yet shows little signs of weakening.

Figure 1: Annual growth in Austrian house prices

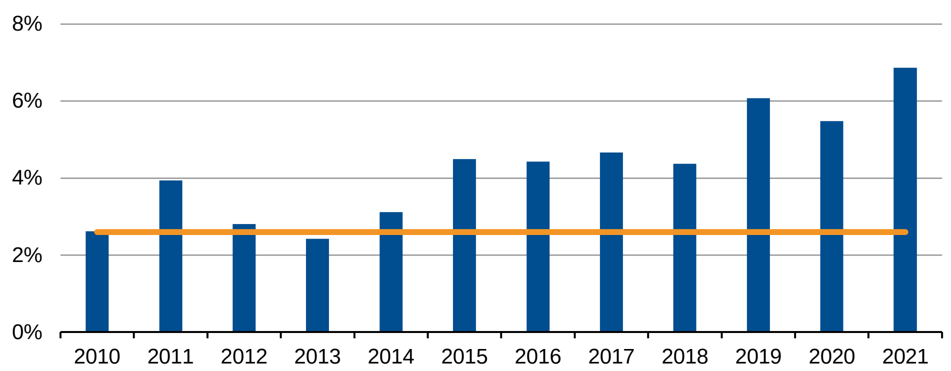


Source: OeNB

Growth is no longer only restricted to the urban Vienna region; it has spread throughout the country. In a European context, the Austrian house price boom is exceptional. Since 2010, house prices have more than doubled, compared to "only" around 45% in the EU.

What is worrying is that the current boom is heavily debt-fuelled and underwriting standards have loosened in recent years. Mortgage lending information provided by the Austrian central bank (OeNB) shows that more than half of new mortgages have an LTV of more than 90% and for every fifth mortgage, payments eat up more than 40% of household income. Banks' mortgage origination averaged more than 4% versus 2.6% in the Euro Area.

Figure 2: Annual change in mortgage origination vs euro area average



Source: OeNB, FMSB

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Macroprudential authority to introduce lending limits

Banks have not followed sustainable lending standards

The Financial Market Stability Board (FMSB) has been highlighting the build-up of risks in the residential real estate sector since 2016, when it started to promote 'sustainable lending standards'.

Unfortunately, with little success. Banks only paid lip service to the non-binding recommendations, which has now prompted the regulator to introduce legally-binding lending limits (see Consultation process begins for new FMA standards on residential real estate lending).

Legally-binding lending limits at the door

The FMA's proposal translates the FMSB's recommendations and includes a loan-to-value (LTV) limit of 90%, maximum debt servicing capacity (DSTI) of 40% and loan terms that should not exceed 35 years.

20% flexibility quota reduces effectiveness of limits

But Austrian regulators also decided to grant a very generous 20% flexibility quota, already weakening the well-intended and necessary measures. Other countries facing elevated house prices, like Norway, only allow up to 10% for exemptions.

Balanced LTV limit ensure that borrowers will have skin in the game

We see the fact that the regulator did not opt for the previously rumoured – and in our view overly conservative –hard 80% LTV limit in a favourable light. Despite the concerns about the house price bubble, we believe that the mortgage market, especially when looking at available stock, remains healthy. Household indebtedness is still low and is largely allocated to more resilient, high-income households. This and a functioning rental sector make an abrupt price correction unlikely.

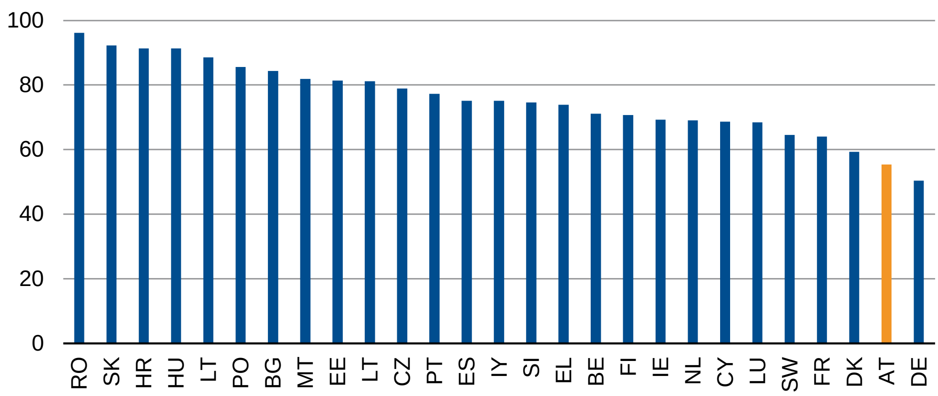
Enough room to increase rates of home ownership

As highlighted in our previous analysis (see Austria poised to introduce regulatory measures to slow house-price boom), an 80% LTV limit would have marked an end to the dream of home ownership for many middle-income households, which just saved enough during the pandemic to cover transaction fees and taxes related to house purchases. Such a hard limit would have excluded a significant portion of the population from the real estate market and created socials tensions not desired by policy makers.

Too much relaxation will not provide the desired effect

The LTV limit of 90% will ensure that borrowers retain sufficient 'skin in the game' and will help raise Austria's 55% owner-occupation rate closer to the EU average of 70%. However, the high 20% flexibility quota goes too far.

Figure 3: Homeownership rates in the EU



Source: Eurostat

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DSTI limit lacks interest rate component

Stressed DSTI limits credit risk when the tide turns

Regulators have averted their gaze from the emerging risk of higher interest rates. Combining the debt servicing capacity limit with stressed interest rates would ensure that borrowers remain able to serve their debt payments, especially as central banks start normalising their monetary policies. What is already best practice for some Austrian banks should become the market standard. This is not addressed in the current proposal.

The regulator does appear to be aware of the different risk profiles of fixed and floating-rate mortgages but is taking a different route. It is recommending a general DSTI limit of 30%, while a DSTI of up to 40% should only be considered for fixed-rate mortgages where the fixed-rate period covers at least half of the loan term. For a standard mortgage of 30 years, this means a fixed-rate period of at least 15 years.

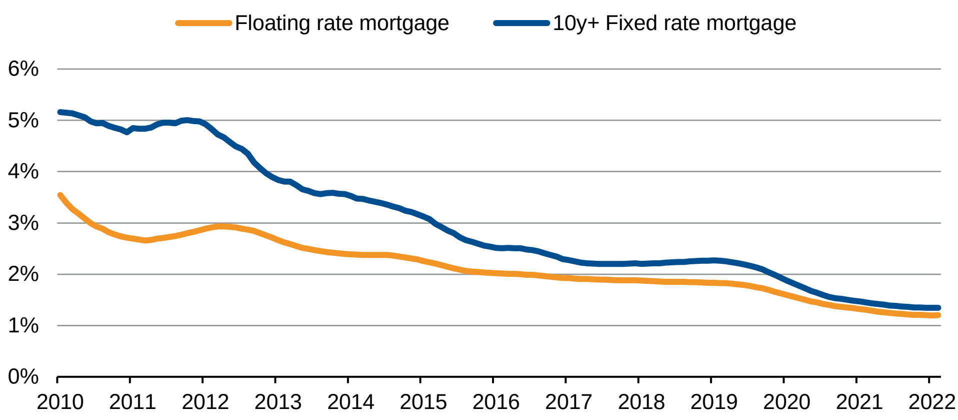
Consumer protection makes fixed rate mortgages too expensive

The problem of this approach is twofold: recent experience has shown that banks will be reluctant to follow such recommendations, while consumer-friendly rules on prepayment penalties make fixed-rate mortgages expensive. If the regulator wants to reduce financial stability risk by promoting fixed-rate mortgages, it will need additional aid from the legislator.

Low prepayment penalties make fixed rate mortgages expensive

Today, Austrian consumer protection limits prepayment penalties for borrowers to only 1% of the outstanding mortgage amount. For Austrian borrowers fixed-rate mortgages therefore seem like a great catch: protection from rising rates and a prepayment option in case interest rates go down. However, as the banks bear the prepayment risk, they naturally charge higher margins.

Figure 4: Average fixed and floating mortgage rates in Austria



Source: OeNB

Share of fixed rate mortgage to fall when rates rise again

Nevertheless, the share of fixed-rate mortgages in Austria has seen a substantial rise in recent years thanks to the ultra-low interest-rate environment and the subsequent compression between fixed and floating-rate mortgages. As a positive, around 60% of new lending is originated at fixed rates, significantly higher than the 20% in 2015.

As banks' refinancing costs have substantially increased in recent months, it is only a question of time as to when interest rates will follow (see European house prices: stretched affordability makes mortgages a luxury, dampens demand). Similarly, the spread between fixed and floating mortgages will likely rise again as this is a function of the absolute level of interest rates.

Current high inflation reduces available income and will incentivise borrowers to go with the cheapest available option. Higher shares of floating-rate mortgages will increasingly expose borrowers to interest-rate risk – especially those that have maxed out LTV and DSTI limits even beyond the banks' generous 20% flexibility quota.

From a financial stability perspective, we call on the regulator to address this risk when implementing the final version of the enhanced macroprudential toolkit.

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