WARNING OF THE EUROPEAN SYSTEMIC RISK BOARD

of 2 December 2021

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

(ESRB/2021/12)

(2022/C 122/03)

THE GENERAL BOARD OF THE EUROPEAN SYSTEMIC RISK BOARD,

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

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 ([1]), 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 ([2]), 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 development in real estate markets may have severe repercussions for the stability of the financial system and the economy as a whole in any given country, which may also lead to negative cross-border spill-overs. 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.

(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

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

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 Bulgaria, this recent assessment has revealed that:

a. Real house prices have grown moderately over the last two years in Bulgaria, increasing on average by about 3,5 % year-on-year until mid-2020. Since then, real house price growth has accelerated to around 7 % as of mid-2021, also reflecting base effects from lower house price growth in the first half of 2020. Estimates produced by Bulgarian National Bank show that house prices were slightly overvalued at the end of 2020.

b. At the same time, annual growth in household loans for house purchase has accelerated significantly over the last years in Bulgaria, reaching 13 % in August 2021 in real terms.

c. According to the European Banking Authority, the level of non-performing loans in the RRE sector in Bulgaria stood at 5,3 % in the second quarter of 2021 ([3]). At the same time, the high coverage ratio of these loans (48,1 % compared to 25,7 % for the Union as a whole) is an important mitigating factor.

d. Against this background, household indebtedness in Bulgaria has been relatively low but has increased somewhat during the COVID-19 pandemic. Moreover, the share of homeowners with a mortgage is very low. As a result, the stock of mortgage loans is at a relatively low level in Bulgaria, representing 27 % of GDP in total (i.e. including corporate loans collateralised by commercial immovable property) compared to 52 % for the Union as a whole in 2020. However, a large majority of loans are at variable rates, making households vulnerable to significant interest rate changes.

e. At the same time, banks operating in Bulgaria have a relatively high level of own funds, with the Tier 1 capital ratio reaching 24 % in December 2020. Thus, if the vulnerabilities related to the RRE market continue to grow, the banking sector's high absorption capacity would be a mitigating factor to the financial stability risks that could be accumulating. Another specificity of the banking sector is the predominant use of the Standardised Approach for credit risk exposures, which mitigates potential risks related to RRE. The share of risk-weighted assets as a proportion of total assets remains above 50 %. Accordingly, the effective risk weight of banks using the Standardised Approach for RRE loans to households is 48 %, while the effective risk weight of banks using internal ratings is 25 %.

f. In comparison with the Union countries overall, although the share of mortgage loans in banks' portfolios is limited and the level of household indebtedness is currently low, the favourable conditions for mortgage financing could pose a risk, on the medium-term horizon, of a spiral developing between house prices and mortgage credit. On the one hand, rising house prices means that the value of the collateral for real estate loans increases, thereby allowing for higher leverage on the part of borrowers. On the other hand, house price growth is usually accompanied by positive macroeconomic developments, which may lead to loosening of the lending standards adhered to by credit providers. At the same time, an increasing supply of real estate loans may represent additional upward pressure on house prices. Over a medium-term horizon, such a spiral could lead to a credit-driven house price bubble and excessively indebted households.

g. The ESRB acknowledges several measures that are in place in Bulgaria that mitigate the current RRE vulnerabilities. In particular, the positive countercyclical capital buffer (CCyB) rate is an appropriate tool by which to address vulnerabilities related to the rapid credit growth, which has been widespread across sectors, and increase the resilience of the banking sector. It was decided in September 2021 that the CCyB would be increased from 0,5 % to 1 % with effect from 1 October 2022. The ESRB also notes that a legal framework for

([3]) European Banking Authority Risk Dashboard, available at: https://www.eba.europa.eu/risk-analysis-and-data/risk- dashboard borrower-based measures was established in Bulgaria in 2019, and that, in accordance with Article 124 of Regulation (EU) No 575/2013 of the European Parliament and of the Council ([4]), a risk weight floor is applied to mortgage loans with relatively higher loan-to-value ratios for banks that follow the Standardised Approach. A weight of 35 % is assigned to a part of exposure secured by mortgages on residential property that does not exceed 70 % of the collateral value.

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. In addition to the currently applied capital-based measures, the introduction of borrower-based measures would be appropriate in order to act pre-emptively against the potential build-up of a spiral between house prices and mortgage credit.

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

HAS ADOPTED THIS WARNING:

The ESRB has identified medium-term vulnerabilities in the residential real estate sector in Bulgaria 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 growth in mortgage credit, signs of house price overvaluation and the absence of borrower-based measures that could mitigate the build-up of risks related to the RRE 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

([4]) Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).