SEPTEMBER 2016

vdp

Residential property loans continue to rise – cause for concern?

Construction activity, transactions and current trends in financing volumes

by Dr. Franz Eilers and Thomas Hofer, vdpResearch, Berlin

According to common indicators, the German housing market is showing increasing signs of a very powerful upturn. Rents and prices are rising faster, construction and transaction volumes are hitting new highs, while lending and credit volumes have recently started to pick up again. Some market watchers consider that these observations provide evidence of a critical development. The media, at any rate, have recently begun to refer to the possibility of a debt fuelled housing bubble in Germany.

Starting from the trend in lending, this contribution initially examines the link between lending growth and changes in property prices as well as with the rise in construction and transaction volumes. It then extends the analysis to include the 1990s and considers whether current trends are similar to the pattern of the first half of the 1990s. As is well known, the boom in the housing market at that time gave way to a very long period of recession and stagnation.

01 Marked rise in disbursements of residential property loans

Disbursements of new home loans by credit institutions and insurance companies have grown steadily since 2010. While the annual rate of increase was initially between 5% and 9%, new business increased sharply in 2015 by about 16%. Overall, residential property loans of about EUR 180 billion (internal and external remortgaging) were disbursed last year – about EUR 68 billion, or 60%, more than in 2009.

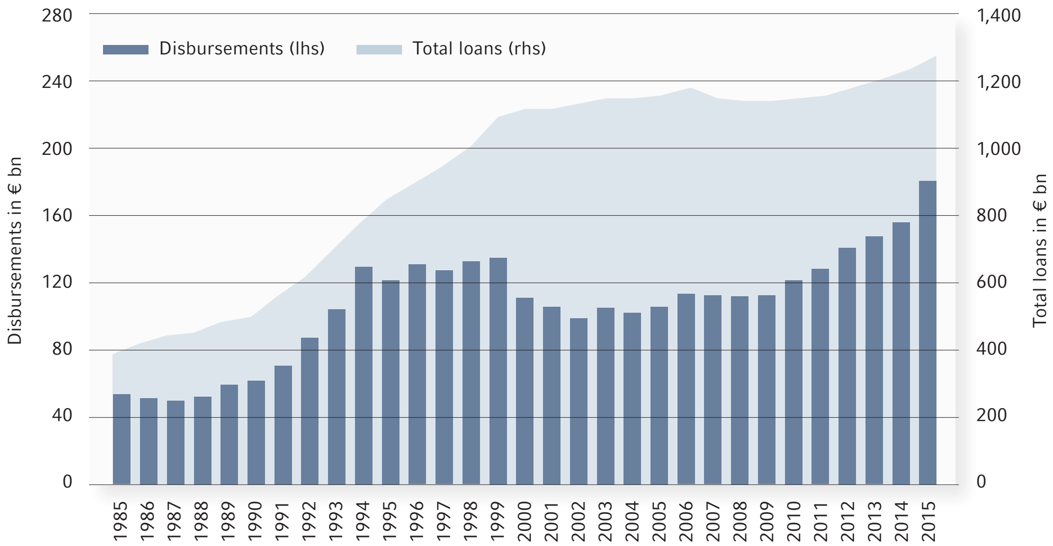
An increase similar to that seen in recent years last occurred in the first half of the 1990s (see chart 1). At that time, a powerful revival in new construction activity in western Germany and exceptionally heavy investment in the housing stock in eastern Germany led to a rapid increase in residential loans. Very high growth rates were achieved primarily in the years from 1992 to 1994. A period of stagnation at a high level followed in the second half of the 1990s, resulting in private debt in the form of existing mortgage loans continuing to expand rapidly. This changed at the turn of the millennium. As vacancies rose and schemes to promote home ownership were scaled back, investment in the housing market declined sharply for years. Disbursements fell for a time before moving into a period of stagnation from 2006 to 2009. As a result, the growth in total lending was dampened considerably. Indeed, the years from 2006 to 2008 aggregate lending actually declined for the first time. A pick-up in disbursements halted the downward trend in 2009/2010. However, the current growth in debt is comparatively flat compared to the strong growth rates for disbursements.

02 Disbursements and total lending

What are the reasons for the sharp rise in disbursements and why is total lending growing at a comparatively slow rate? Home loans are taken out for a variety of reasons. They include the modernisation or maintenance of a property and the construction of a new, or the purchase of an existing, home. Finally, the level of disbursements is determined not just by the sum total of individual investments, but also by own funds available for such purposes. All these reasons are summarised in the following chart as aggregates, which for the most part can be statistically verified. Investment in the construction of new residential properties (new construction volume) and amounts spent on modernisation and maintenance of existing properties are calculated separately and together by the German Institute for Economic Research (DIW).

CHART 1

Disbursements of residential property loans in Germany



Source: vdpResearch (disbursements); Deutsche Bundesbank (total loans) vdpResearch first collects information on money spent on the acquisition of residential properties and then records loan disbursements. By definition, the latter relate only to the debt-funded part of total lending. The average debt ratio can be calculated as the resultant. Current total lending is equal to total lending of the previous period plus disbursements and less repayments. Total lending is quantified by Deutsche Bundesbank and, since disbursements – as stated above – are known, repayments can be determined as the resultant.

CHART 2

Disbursements and residential property loans: determinants

New construction
\+ Modernisation/maintenance (construction work on existing properties)
= **Housing construction**

\+ Existing home sales
= **Total financing volume**

x Average debt ratio
= **Loan disbursements**

– Loan repayments
\+ Total lending of previous period
= **Current total lending**

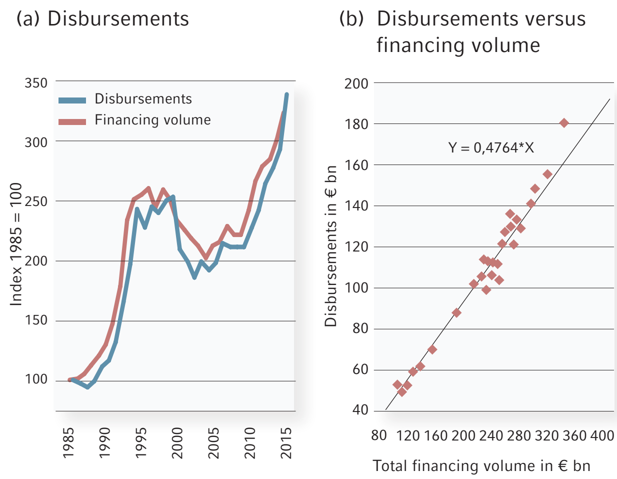
The variables shown in chart 2 are backed up by data and discussed and analysed in terms of their current and historical trends below.[1)]

03 Total lending and disbursements

Total financing volume comprises, first, new housing construction and the modernisation and maintenance of existing properties and, second, the total amount spent on the acquisition of residential properties.[2)] Charts 3a and 3b compare the construction and transaction volumes with loan disbursements to determine whether, and to what extent, the debt ratio has changed over time. Chart 3a shows a close correlation between financing and disbursement volumes. In other words, in all the years in the observation period there was a close link between lending and investment and transaction volume.

CHART 3

Total financing volume and disbursements, 1985 to 2015



Sources: disbursements: DIW, GDV, vdpResearch; total financing volume: vdpResearch

The correlation between total financing and debt financing (disbursements) indicates that the funding structure has remained largely stable: the average share of debt funding in housing investments and transactions has been just under 48% over the last three decades with slight fluctuations (see chart 3(b)[3)]). It should be noted that the significance of the various segments of the residential property market is certainly subject to change over time and that the extent to which they need debt financing varies. For example, investments in the housing stock relative to new construction play a larger role than 20 years ago. Nevertheless, these structural shifts do not appear to have been sufficiently pronounced to have had an appreciable influence on the overall result.

[1)] With regard to the inclusion of the new federal states, the following should be kept in mind; depending on the time series, the date of integration varies between 1990 and 1994. As market structures only just began to emerge in the new federal states in that period, they accounted for only low volumes and the ensuing inaccuracies therefore appear insignificant. Nevertheless, there may be slight distortions.
[2)] To avoid double counting, it is necessary to adjust new construction volume for the properties that are sold in the year of completion on the market for existing properties.
[3)] Each dot in chart 3(b) represents the linear combination of financing volume and disbursements.

04 Housing construction

In 2015, total housing construction amounted to about EUR 192 bn, which represented a 4.5% y-on-y rise. As in previous years, new construction (+7.6%) accounted for more of the growth than modernisation and maintenance work on existing properties, which increased 3.3%. However, in absolute terms, new housing investment is far less important than work on the existing housing stock, which accounts for more than two-thirds of total housing construction.

The renewed growth in new construction since 2010 is reflected in all segments, albeit in varying degrees. The number of completed units in new multi-family houses has risen in particular. However, in this connection and also with regard to owner-occupied housing, it must be kept in mind that completions are well below the numbers reached at the start of the 1990s. While 248,000 new dwellings were handed over to the market last year, the corresponding figure 20 years earlier was 603,000 (see Chart 4b).

There are several reasons for the current revival in the construction of multi-family buildings. In the first place, mention should be made of the low level of new construction in the preceding 10 to 15 years. This led to a shortfall in regional supply in connection with

a) population shifts in Germany towards economically strong conurbations and university cities and
b) net migration from other countries.

This resulted in rents under new leases rising, initially hesitantly and then more strongly. Yield-oriented multi-family housing, which for a long time did not offer any commercial prospects, has become more attractive again. It therefore comes as no surprise that the readiness to make new investments has been rising steadily for several years, especially in view of the massive support from historically low interest rates.

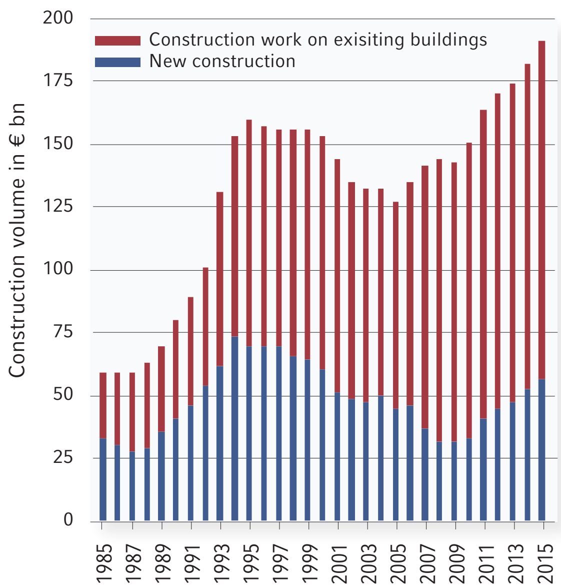
In all probability, the multi-family housing segment will continue to grow in the coming years and remain the main driver of new housing construction. This is indicated by a high construction backlog and the number of approved apartments in multi-family houses. In 2015, about 137,000 apartments were approved in new residential buildings with three or more units, which was 6.9% higher than in the previous year.

In view of the persistent tightness in urban residential markets, this trend must be viewed as an absolute necessity.

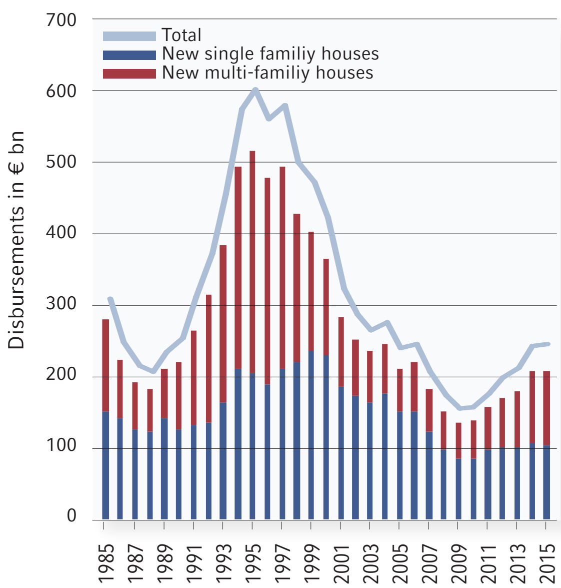
CHART 4

Completed dwellings and housing construction volume

(a) Housing construction volume



(b) Completed dwellings



Sources: volume of housing construction: DIW; completed dwellings: Federal Statistical Office

Particular attention should be paid to the proportion of total housing construction that is described in the statistics as “construction work on existing buildings” or “modernisation and maintenance”. This part has long formed a stable foundation for construction activity (see Chart 4a). Over the long term, construction work on existing buildings has – with the exception of the years 2001 - 2003 – increased steadily. In 2015, it accounted for about 70% of total housing construction. There are two reasons for this growing significance. First, a steady increase in the housing stock requires corresponding spending on maintenance and adjustments to quality standards. Second, the trend reflects the fact that measures aimed at raising the energy efficiency of residential buildings have become increasingly relevant over the years.

05 Existing home sales

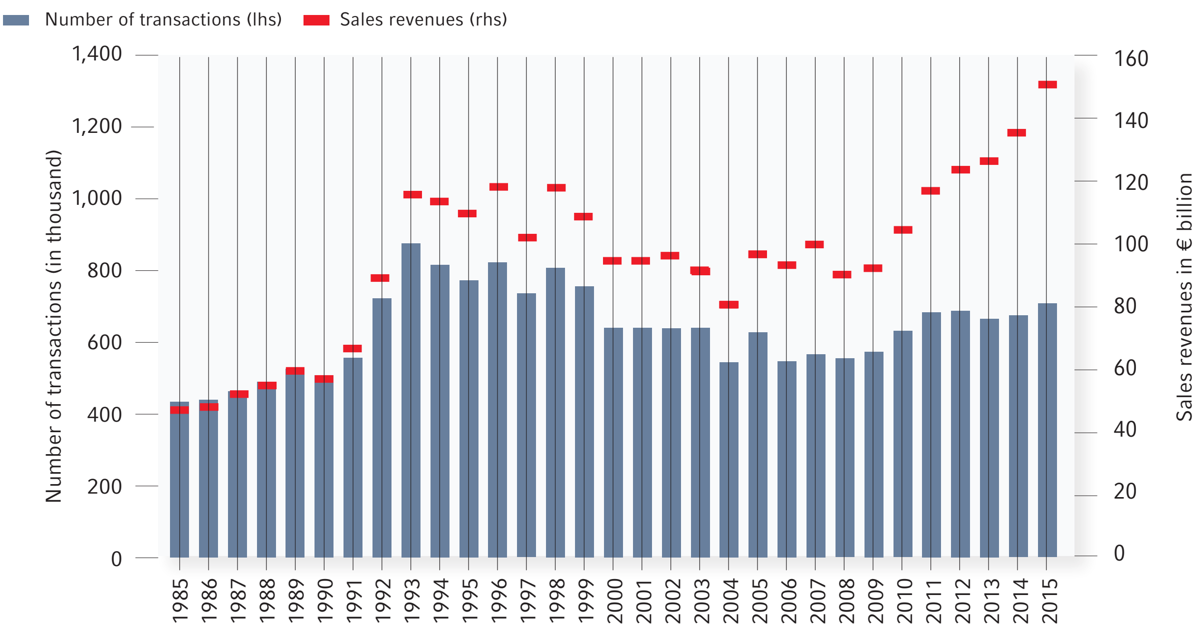
In addition to construction volume, sales affecting financing volume in the market for existing properties determine the combined financing volume which has to be provided by equity and debt. Chart 5 shows the annual number of transactions and corresponding existing home sales in billions of euros over the entire period of observation.

The trend in the number of transactions in the market for existing properties over the entire observation period has been similar to that seen in construction volume. At the start of the residential property boom in the 1990s, purchases soared. After the boom subsided in the mid-1990s, the number of transactions generally declined for a long time up to 2007/2008, which was only interrupted by repeated periods of stagnation. The reasons were cyclical and structural. Initially, the overall economic situation deteriorated and purely quantitative demand was covered. The generation of baby-boomers had largely purchased their homes, while birth rates in the following years were far lower. In addition, an unfavourable job market and the ensuing financial uncertainty dampened demand.

The debate about demographic trends in Germany and the prospects for the housing market became excessively pessimistic – especially in public – resulting in a considerable lack of confidence about how the residential market would develop in the future.

CHART 5

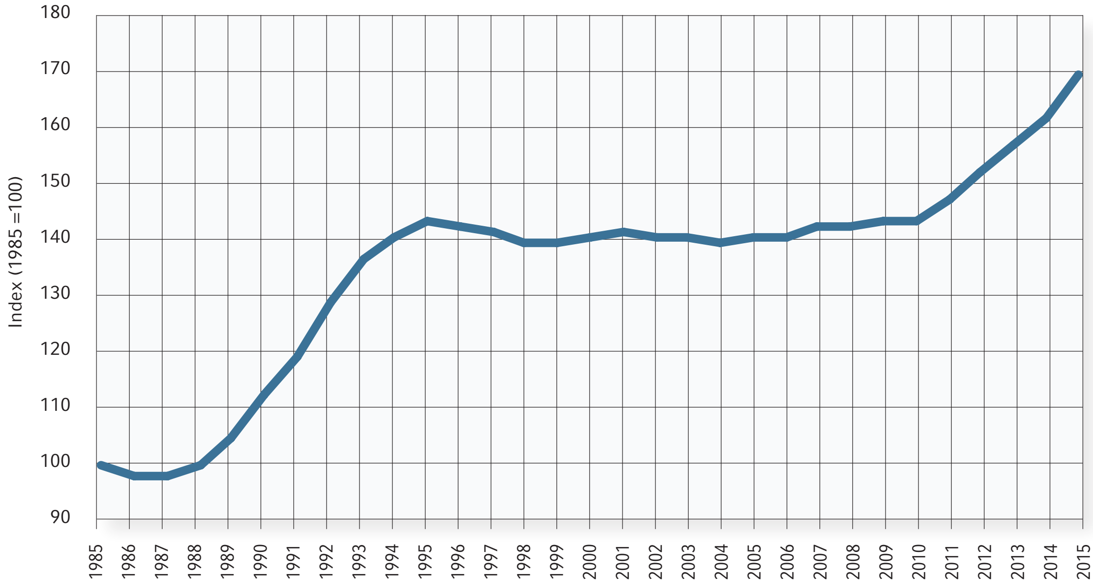
Transactions and sales revenues relating to existing residential properties in Germany



Source: Up to 2006 GEWOS and own calculations based on data of the Federal Statistical Office (real estate transfer tax) and DIW; from 2007 vdpResearch

CHART 6

Prices for owner-occupied dwellings



Source: vdpResearch

Transactions have been back on an upward path since 2009/2010. This is, however, very flat and has been more akin to a sideways move since 2013. This is probably due to available supply rather than existing demand. In many regions, potential sellers are holding back, first, because they assume that prices will rise further and, second, because there are no profitable investment alternatives.

Sales revenues are largely in line with transactions. This comes as no surprise given the close correlation of sales revenues with the number of transactions. However, two exceptions should be pointed out. In the first half of the 1990s, revenues rose faster than transactions due to rising prices. While the basic pattern has been similar in the years since 2010/2011, the trend has been much more pronounced. While transaction numbers have shown little movement since then, sales revenues have continued to grow strongly without interruption. The key reason for this development was, as indicated above, the steep rise in prices in the German housing markets (see Chart 6). It does not pay to sell if prices continue to be driven by demand for real estate investments and if no profitable alternatives are available. The persistent rise in prices and extraordinarily low interest rates are therefore encouraging investors to bank on an ongoing upward trend and the longer this upturn persists, the more sustainable and credible it will appear to some.

06 Conclusion

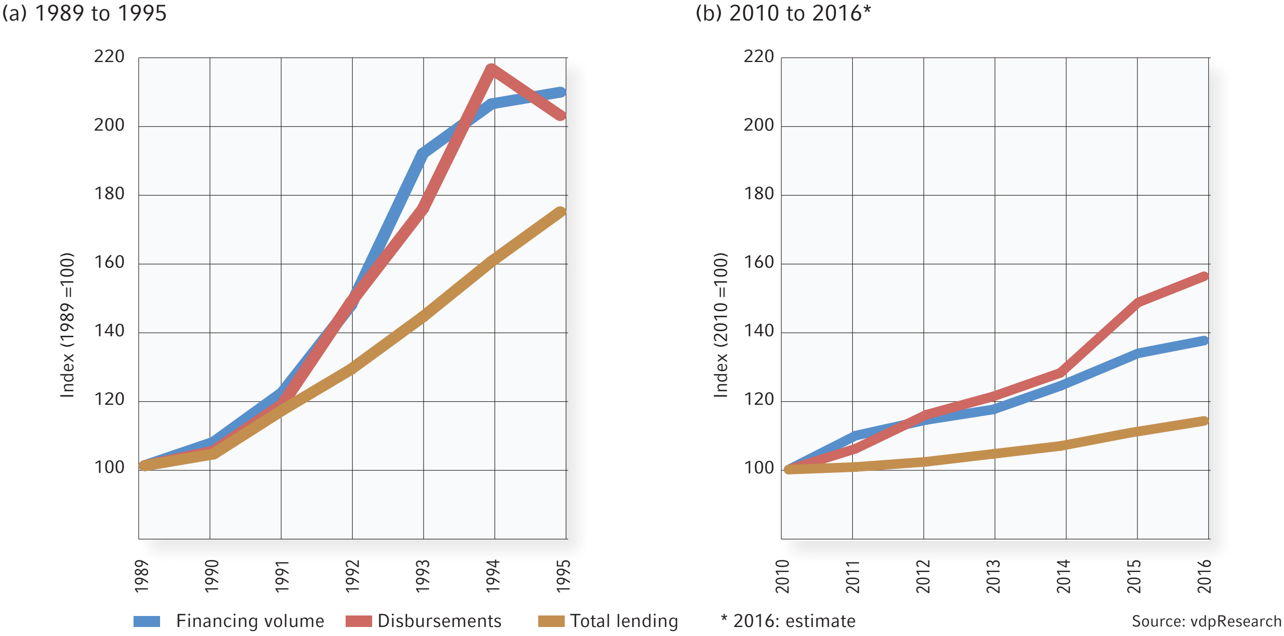
Total financing volume has increased considerably in recent years because both the amount of new construction and work on the existing housing stock and revenues from existing home sales have grown rapidly. Sales of existing properties, and above all higher residential property prices, have contributed the most to growth.

The growth in total financing volume combined with only a moderate increase in the debt ratio has had a slightly disproportionate effect on disbursements. Since 2010 the latter grew by more than 50%, while total financing volume rose by 40% in the same period.

Some observers take a clearly critical view of the current rise in house prices and loan disbursements. These two market variables have not moved in tandem in such a manner since the first half of the 1990s. As outlined above, the housing and disbursement boom at that time was followed by a long downturn and period of stagnation. Does a similar development lie ahead? If one assumes that housing markets – like other markets – are subject to more or less recurrent fluctuations, it makes sense to take the 1990s as a reference period for assessing of current developments. The following chart

CHART 7

Comparison of upswings: 1989 to 1995 and 2010 to 2016*



* 2016: estimate

Source: vdpResearch

therefore compares the periods (a) 1989 to 1995 and (b) 2010 to 2016. For better comparability, the time series are shown as indices in both charts. The indices are at 100 in the first year of the respective upswing. The vertical axes in charts (a) and (b) are also scaled identically.

The charts reveal two aspects:

(1) Total financing volume and disbursements correlate closely over time in (a) and (b).
The charts also show that total lending lagged behind the development both then (a) and today (b).

(2) For the period from 1989 to 1995, all time series show a significantly greater increase than for the post-2010 period. This difference is most apparent in the change in total lending. Although disbursements have been rising rapidly for years, the growth in total lending is very flat.

Taken together, the comparison reveals very clear differences between the current market trends and those of 20 years ago. If these differences are taken as a measure for assessing the current up-turn, the current development can clearly be described as moderate. However, it should be pointed out that the current upswing is characterised primarily, although not just, by rising prices for existing homes. Construction of new dwellings in the regions with considerable gaps in housing supply has been rising for a few years, but has not yet reached a level sufficient to depress price increases to lower growth rates. Moreover, a further factor is that total lending is currently growing at such a low rate because it consists to a very large extent of older loans, and repayments therefore account for a large part of the annuity.

Provided that there are no significant macroeconomic disruptions, investment in new residential buildings is expected to continue to grow over the coming years. Construction work on existing buildings should continue to increase at a moderate pace. In the market for existing properties, the volume of transactions will also probably continue grow due to further price rises. In the near term, therefore, disbursements of home loans are expected to increase further.

This trend should not involve any unusual risks for banks as long as their lending standards remain conservative. The potential risks for purchasers of residential properties are also limited provided that they can lock in cheap funding terms for as long as possible. However, buyers will remain faced with the risk that property prices will fall below current levels if the residential market eases or if the general environment deteriorates.

VERBAND DEUTSCHER PFANDBRIEFBANKEN

The member institutions of the Association of German Pfandbrief Banks (Verband deutscher Pfandbriefbanken, vdp) have been the market leaders in commercial real estate finance in Germany and hold sizeable market shares in residential real estate finance as well. As the representative of its member banks, the vdp performs this function vis-à-vis all executive bodies of politics on both the national and the European stage and a wider public.

The vdp's know-how is tailored towards the specific interests of the Pfandbrief issuers, namely, the Pfandbrief business and the underlying business fields property finance, public-sector lending, ship and aircraft finance. The vdp assists its member banks also in regulatory matters and represents them vis-à-vis national regulatory authorities. By means of group governance, member institutions exchange information and experiences in vdp committees, which are then summarized and developed into market standards. The vdp also assists its member banks in the efficient structuring of their specialized loan or issuance businesses.

Association of German Pfandbrief Banks
Georgenstrasse 21
10117 Berlin, Germany
Telephone: +49 30 20915-100
E-mail: info@pfandbrief.de
www.pfandbrief.org

vdpResearch GmbH is a subsidiary of the Association of German Pfandbrief Banks. It works extensively, from a lending perspective, on compiling, analysing and forecasting real estate prices, focusing both on individual properties and real estate markets as a whole. Its remit includes providing comparative prices, comparative rents and other evaluation criteria relating to individual properties. At the same time it is charged with compiling and forecasting market price trends by property type on a regional and national basis. In order to carry out these tasks, it uses analytical tools specific to the real estate market, together with comprehensive models designed to examine market trends as a whole.

Figures provided by vdpResearch are regarded by numerous banks as a crucial tool for valuing and assessing property and market risks. The Germany-wide real estate price indices which it prepares for the Association of German Pfandbrief Banks are also directed at interested members of the public. These provide an overview of general trends in real estate prices in Germany.

vdpResearch GmbH
Georgenstrasse 22
10117 Berlin, Germany
Telephone: +49 30 206229-262
E-mail: info@vdpresearch.de
www.vdpresearch.de