Analysis

Nordic countries are vulnerable to housing market risks aggravated by the coronavirus pandemic

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The coronavirus (COVID-19) pandemic is dampening the Nordic housing market in many ways. The economic outlook and consumer confidence in the economy have deteriorated precipitously. The restrictions imposed under the state of emergency are affecting the activities and financial position of banks, real estate agents and customers. Home sales have decreased and sales times are lengthening. The dependence of banks on wholesale funding renders them vulnerable to tensions in the international financial markets.



The coronavirus pandemic threw the international financial markets into unprecedented turmoil

in March 2020 and brought the world economy to an abrupt halt. Estimates of the duration of the pandemic and its impacts on health and on the economy are continuously being updated. While the pandemic hit the economy as an external shock, it may – if protracted – trigger vulnerabilities that have long been building up in the financial system and in the housing market.

Economic growth in the Nordic countries was slowing down already before the outbreak of the coronavirus pandemic. The coronavirus crisis has demanded rapid updates to estimates of economic developments for the immediate years ahead. The economy is expected to contract significantly in 2020 in all the Nordic countries. Employee cooperation negotiations have increased and the number of layoffs and unemployed jobseekers has risen abruptly. The risk of a protracted recession has increased, but a moderately swift recovery is still possible after the most acute phase of the crisis.[1]

The resilience of the Nordic banking system has been strengthened in various ways since the global financial crisis. The solvency and liquidity positions of banks have been improved and new macroprudential instruments have been introduced to curb lending for house purchases and excessive household indebtedness. These requirements were eased when the pandemic broke out, and banks and households are utilising buffers to mitigate the economic impacts of the recession.

In response to the coronavirus crisis, Swedish banks have been given the permission to grant mortgagors an exemption from the financial supervisory authority's existing amortisation requirements.[2] In Norway, banks are allowed greater flexibility in, for example, the application of the maximum loan-to-value (LTV) ratio, i.e. the loan cap.[3] Banks operating in Finland, in turn, have granted temporary interest-only periods for housing loan customers.

While housing markets have often been at the centre of economic and financial crises[4], vulnerability to the risks in the market varies by country. Recessions have been particularly deep and protracted when they have been preceded by excessive household indebtedness and debt-driven overheating of the housing market.[5] For example, the global financial crisis in 2007–2008 had its origins in the US housing market, and the global economic downturn that followed triggered a recession in all the Nordic countries. Among the Nordics, problems in the housing market were severe and protracted only in Denmark, where house prices had risen rapidly prior to the crisis and declined for many years thereafter.

History has also known epidemic-driven recessions and housing market disruptions. These crises have remained short-lived, however, with only limited effects on financial stability. The SARS epidemic, for example, spread to dozens of countries in 2003 and hit Hong Kong particularly hard. House sales in Hong Kong temporarily declined dramatically, but the recovery was swift and the

impact on house prices remained modest.[6]

Nordic financial system vulnerable to housing market risks

The Nordic financial system is vulnerable to many risks intensified and triggered by the coronavirus pandemic. These risks may materialise and spread across international financial markets, the real economy and the residential and commercial real estate markets. The Nordic countries share many common structural vulnerabilities in their financial systems, and banks are therefore exposed to similar credit, investment and funding risks. The current recession increases the risk that long-accumulated vulnerabilities will begin to translate into losses.

The major role of housing finance and the housing market in the Nordic financial system has long been recognised as one potential source of risks. Significant common vulnerabilities associated with the housing market are high household indebtedness, the notable share of housing loans in bank lending to the public, the large share of covered bonds in banks' market-based funding and liquid assets, and the importance of wholesale funding in bank funding in general.[7] Housing loans account for more than 40% of total bank lending in all the Nordic countries.

In addition to housing loans, Nordic banks have granted a high volume of loans to the commercial real estate sector. The share of these loans in total bank lending to the corporate sector varies among the Nordics from around 40% to some 60%. In previous crises, banks have suffered significant credit losses on loans to the commercial real estate sector, as the sector is highly cyclical. Risks in the commercial real estate market may spread across borders both through banks and through investors.

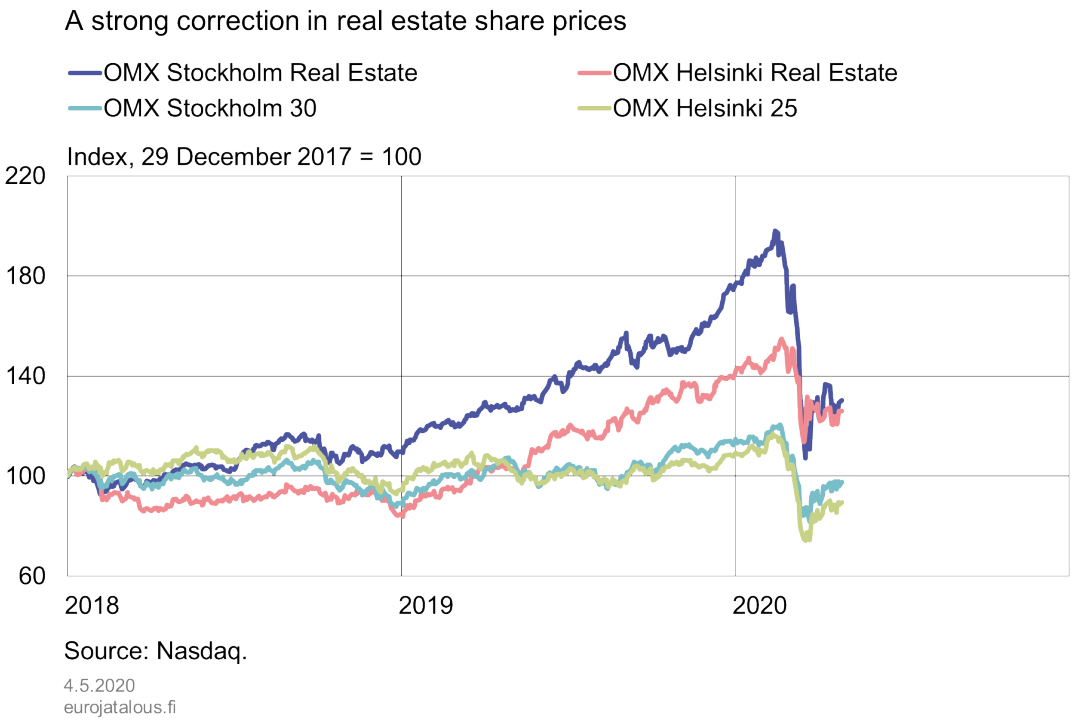
The banking sectors of the Nordic countries are large in relation to the size of the economy, concentrated and interconnected. The largest banks operate in several countries in the region. The Nordics are also important trading partners to each other, and international trade as a whole plays a significant role in the economy. For these reasons, financial and economic crises could have particularly severe repercussions for the Nordics and spread from one country to another.[8]

The Nordic financial system has many strengths. The banking sectors of the Nordic countries are financially sound and enjoy good credit ratings. This improves their resilience against losses and their ability to ensure financial intermediation under different circumstances. The risk resilience of the Nordic banking sectors is supported by their good profitability in a European comparison. This is partly due to the low level of non-performing assets and credit losses. The Nordic financial systems and housing finance have functioned without major issue in the difficult economic situation during and after the global financial crisis.

The coronavirus pandemic was quickly reflected in the stock and bond prices of mortgage lenders

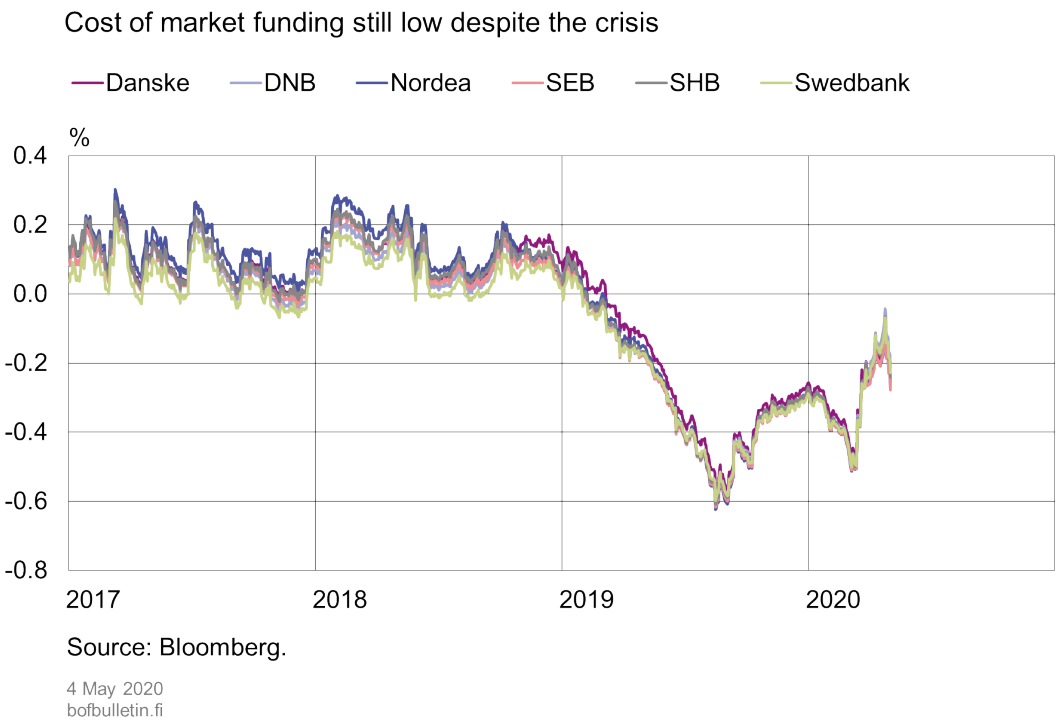
The stock prices of banks fell worldwide as soon as the coronavirus crisis intensified (Chart 1). Although Nordic banks have long enjoyed investor confidence, their stock prices have also been affected by suspicions that have emerged over the past few years about shortcomings in banks' anti-money laundering efforts. With the steep drop in stock prices, it is important for banks that the cost of their bond market funding has not risen notably.

Chart 1.



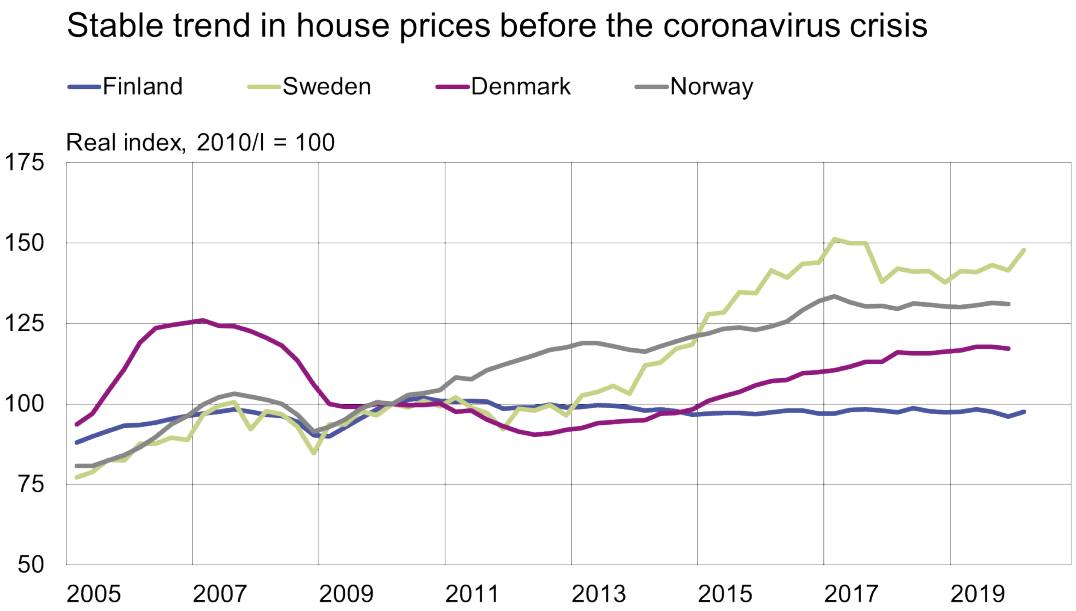
Nordic banks have granted a high volume of loans to companies in the real estate sector. The stock prices of listed companies in the sector rose steeply, especially in 2019, as relatively stable house prices and the popularity of residential property as an investment asset sustained the positive sentiment in the real estate market (Chart 2). In Sweden, the real estate equity index had doubled its value since the beginning of 2018, but after the coronavirus outbreak the index plummeted along with other shares.

Chart 2.



The cost of hedging credit risk increased notably for Nordic banks following the intensification of the coronavirus crisis. The situation has calmed down thereafter (Chart 3).

Chart 3.



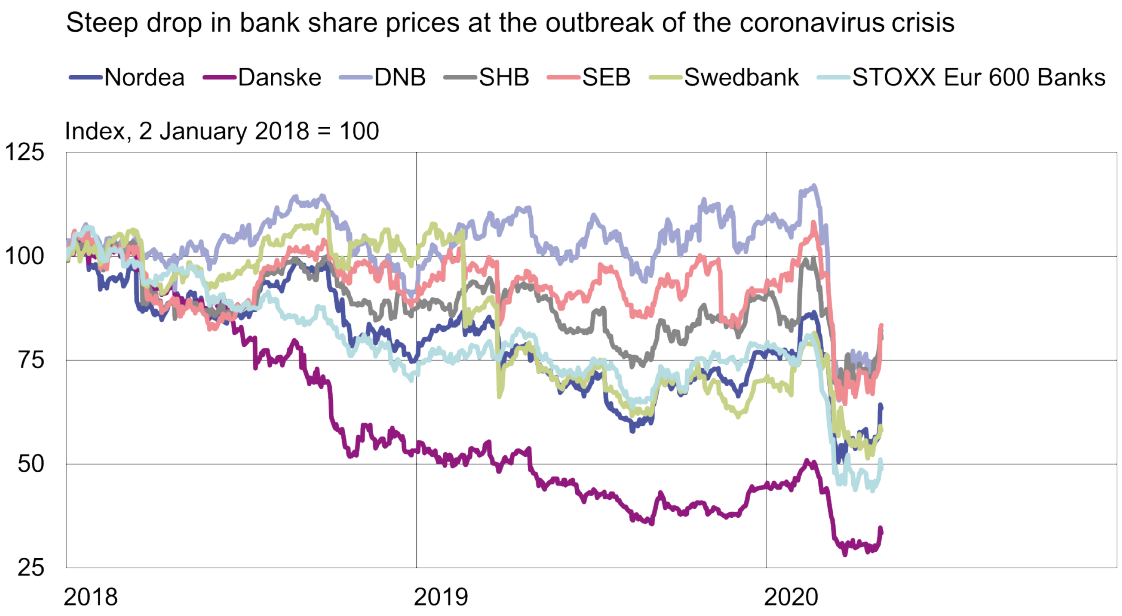
Sources: Statistics Finland, Valueguard, OECD, Macrobond and calculations by the Bank of Finland.

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Covered bonds are an important source of funding for Nordic banks. While funding collateralised by housing loans has been relatively cheap for Nordic banks in recent years, its pricing depends on investor confidence in banks and in the housing market. The prices of covered bonds of large Nordic banks declined at the outbreak of the coronavirus crisis, and thus required yields increased. The yields on these loans are historically still very low, however (Chart 4). The yields have even been negative in recent years, as investors have considered covered bonds to be very safe investment assets. A significant increase in the cost of funding would affect banks' lending capacity and tighten the terms of new loans.

Chart 4.

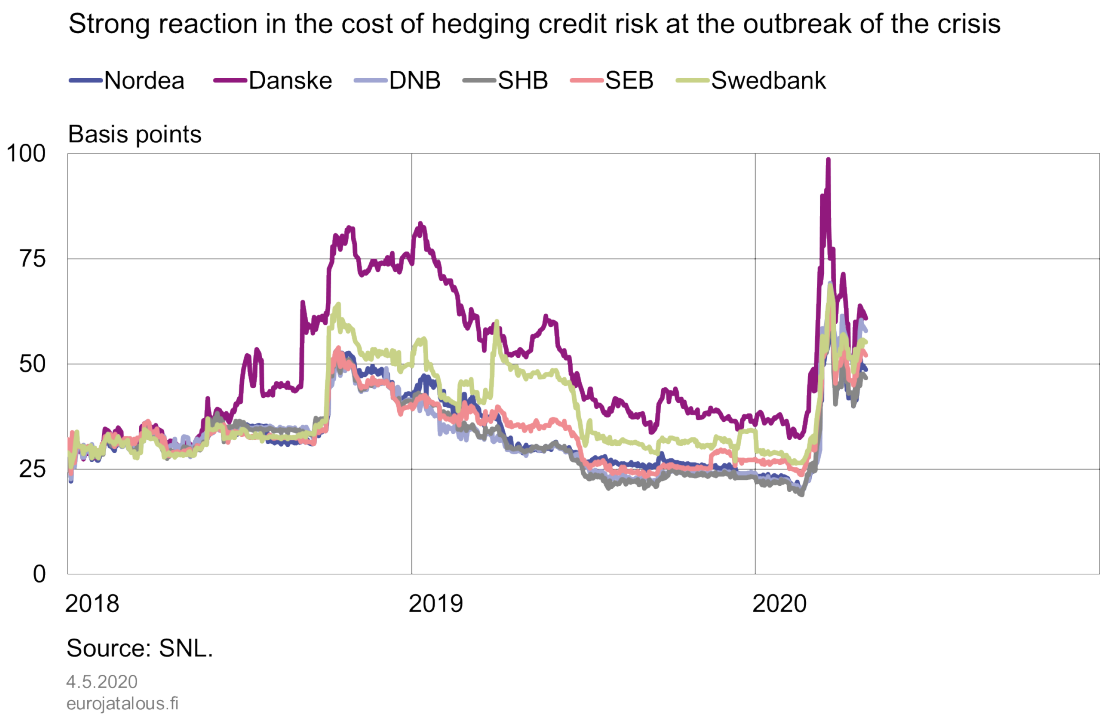


Survey data indicates a decline in residential property sales and prices

The effects of the coronavirus pandemic have been apparent in the Nordic housing market since March 2020, as house sales have decreased for both economic and practical reasons. Due to the rapid deterioration of the economic outlook and the rise in unemployment, households and investors have become more cautious in making major economic decisions. Consumer confidence in the economy has deteriorated precipitously (Chart 5) and consumer intentions to take out a loan or buy a home have abated.

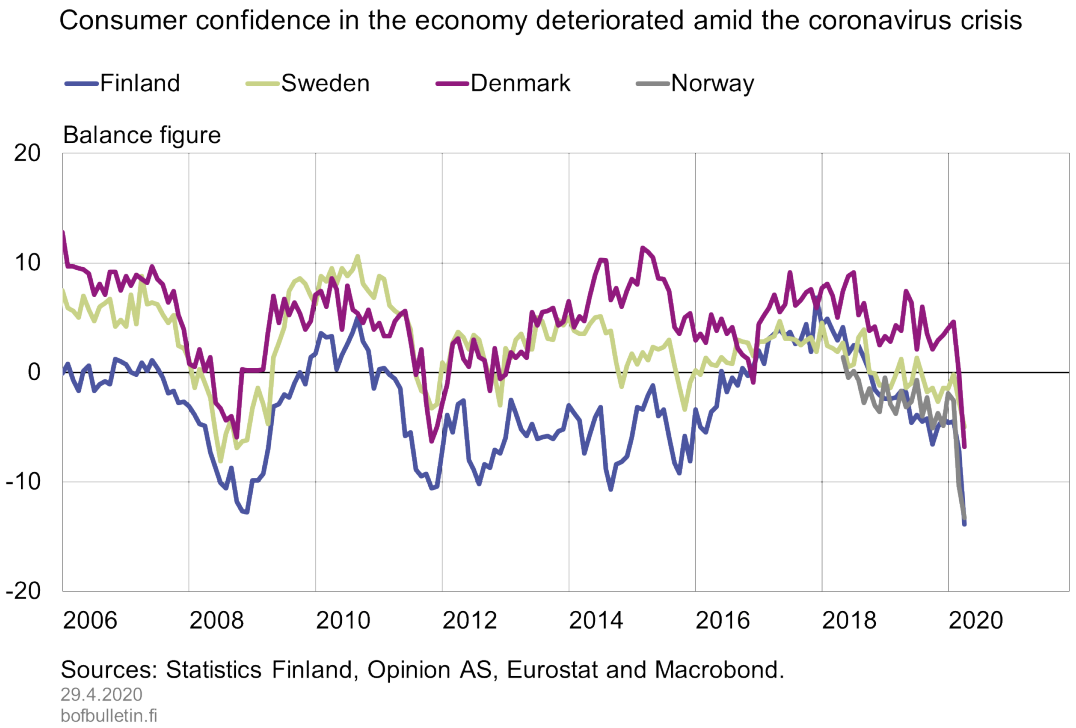
The restrictions prompted by the pandemic are affecting the activities of banks, real estate agents and customers. Digital services have become more important. Real estate agents have made an effort to promote house sales by organising private and virtual home tours. Bank customers have been able to apply for new housing loans via mobile and online banking already before the pandemic. It is also possible to sign the purchase and sale agreement and loan documents electronically.

Chart 5.



The Nordic housing market was still as lively as usual in February, and house sales were increasing as the market was heading towards spring. There were, however, no specific signs of overheating in the housing market. In Sweden and Norway, house prices increased in real terms until 2017, after which there was a correction and prices stabilised (Chart 6). In Denmark, real house prices began to rise in 2012 and were approaching the level preceding the global financial crisis. Compared with the other Nordics, Finnish house prices followed a more stable trend throughout the 2010s, although price differences within Finland increased.

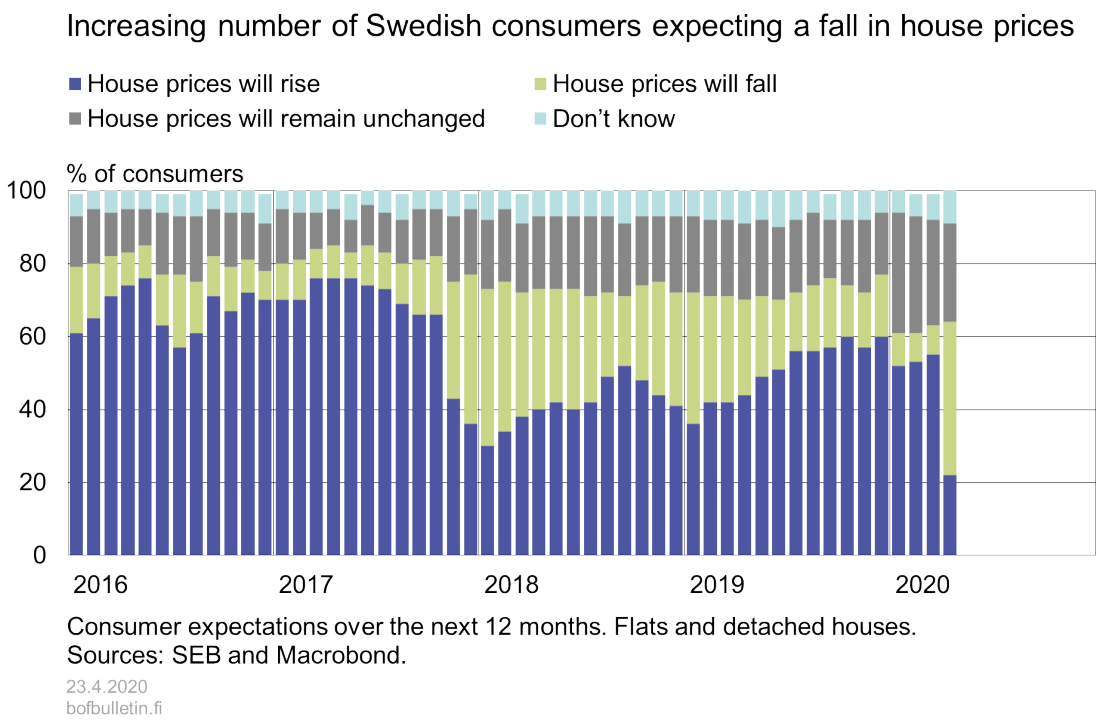
Chart 6.



In the long term, house price developments have diverged significantly among the Nordic countries, which is why assessments of the state of housing markets also differ.[9] In Sweden, house prices are at a historically high level, and so is household indebtedness. The rental market is also strictly regulated, which has contributed to rising house prices. On the other hand, the Swedish financial supervisory authority has assessed that the macroprudential instruments introduced in recent years to curb indebtedness have improved household finances to such an extent that, in the current crisis, banks will not suffer major credit losses on housing loans.[10]

Survey data[11] suggests that an increasing number of Swedes expect house prices to fall in the next 12 months (Chart 7). The share of consumers expecting lower house prices increased from 8% to 42% between the surveys of March and April. At the same time, the share of those expecting higher house prices fell from 55% to 22%. Expectations of this kind tend to become self-fulfilling if households postpone purchase decisions and sellers have to lower their asking prices. However, price fluctuations in the housing market are usually smaller and slower than in the stock market, where trading is rapid.

Chart 7.



According to the Swedish real estate portal Hemnet, the number of new listings of homes for sale submitted in March and early April was higher than usual.[12] This may indicate that, due to increasing uncertainty, households considering the sale of their home have thought it best to place their house on the market quickly. If expectations of a fall in house prices increase further, the number of homes for sale may decrease. In Finland, the real estate portal Etuovi.com has received fewer new listings since mid-March than a year earlier, and fewer homes were for sale in March than in the previous year.[13]

Real estate agents have reported that residential property sales in Finland and Sweden were almost at the same level in March as in 2019.[14,15] Sales of new and existing homes increased by about 2% in Finland and decreased by 1% in Sweden. In the latter part of March, however, house sales were clearly lower than a year earlier. Based on house sales concluded and the number of homes for sale, house prices showed a slight decrease in March, but the change was not very significant. In Stockholm there were signs of a decrease in house prices especially in the latter part of March.[16]

Housing is a significant investment, and the residential and commercial property markets are interconnected through domestic and international investors. In Finland, for example, a significant proportion of international real estate investors are from the other Nordic countries.[17]

Residential investment accounted for around 32% of the Finnish real estate investment market in 2019, which makes residential property the largest individual item before offices and business premises. The coronavirus crisis is having a negative impact especially on hotel and retail property, from which real estate investors are likely to miss out on rental income. Income flows from residential property are likely to remain more stable compared with other real estate investments.

Notes

1. See e.g. https://www.eurojatalous.fi/fi/2020/artikkelit/Scenarios fo the Finnish economy for the years ahead/. ↑
2. See https://www.fi.se/en/published/news/2020/banks-may-now-grant-amortisation-exemption/. ↑
3. See https://www.regjeringen.no/en/aktuelt/temporary-changes-in-the-mortgage-regulation/id2694589/. ↑
4. Reinhart, C. M. – Rogoff, K. S. (2009) The aftermath of financial crises. The American Economic Review, Volume 99, Number 2, 466–472. ↑
5. See e.g. https://voxeu.org/article/great-mortgaging. ↑
6. House prices in Hong Kong were declining already before the epidemic and fell only marginally relative to the previous trend during the epidemic. For further details, see Wong, G. (2008) Has SARS infected the property market? Evidence from Hong Kong. Journal of Urban Economics, Volume 63, Issue 1, 74–95. See also https://www.zillow.com/research/pandemic-literature-review-26643/. ↑
7. In 2019, the European Systemic Risk Board (ESRB) warned the Nordic countries of medium-term vulnerabilities in the residential real estate sector and issued recommendations for action to prevent in particular the risks stemming from the high level of household indebtedness. ↑
8. See also https://www.bofbulletin.fi/en/2018/articles/risks-on-the-swedish-housing-market-also-a-cause-for-concern-in-other-nordic-countries/. ↑
9. See e.g. the European Central Bank's indicators measuring potential overvaluation of residential property prices https://www.esrb.europa.eu/pub/pdf/dashboard/esrb.risk_dashboard200107~5ebd02b8b3.en.pdf. ↑
10. See https://www.fi.se/en/published/reports/swedish-mortgage-reports/the-swedish-mortgage-market-2020/. ↑
11. Survey by the Swedish SEB bank. ↑
12. See https://www.hemnet.se/artiklar/bostadsmarknaden/2020/04/15/utbudet-fortsatter-att-oka (in Swedish). ↑
13. See https://www.etuovi.com/koti/blogi/asuntomarkkinoiden-kysynta-vireaa-poikkeustilassakin/ and https://www.etuovi.com/asuntojen-hinnat-ja-asuntomarkkinat (both in Finnish). ↑
14. See https://kvkl.fi/keskusliiton-asuntomarkkinakatsaus-q1-2020/ (in Finnish). ↑

15. See https://www.maklarstatistik.se/pressmeddelanden/sma-prisrorelser-men-vikande-antal-forsaljningar-i-mars/ (in Swedish). ↑
16. See https://valueguard.se/article/53 (in Swedish). ↑
17. See also https://www.bofbulletin.fi/en/2019/2/finnish-commercial-property-market-increasingly-intertwined-with-foreign-markets/. ↑

Keywords

banks, COVID-19, COVID-19 virus pandemic, financial stability, housing markets, Nordic countries