Analysis

Nordic housing market showing strength, but not without risks

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The Nordic residential and commercial real estate markets recovered quickly from the first wave of the COVID-19 pandemic. House sales and property investment flows have been strong despite the uncertain economic outlook. The rise in house prices – even rapid in some regions – and growth in lending emphasise the existing vulnerabilities of Nordic banks. On the property investment market, the pandemic has reinforced ongoing trends, such as growth in the share of residential property in professional real estate investors' portfolios.



Banks exposed to risks in residential and commercial real estate markets

The Nordic financial system is vulnerable to risks in the housing and commercial property markets.[1] Banks' key vulnerabilities are related to the provision of credit to households, investors and other operators in the real estate sector. Banks are also exposed to funding and investment risks on the covered bond market. Any losses incurred would weaken the profitability, capital adequacy and liquidity of banks, with potential for even greater ramifications through bank interlinkages and economic interconnectedness of the Nordic countries.[2]

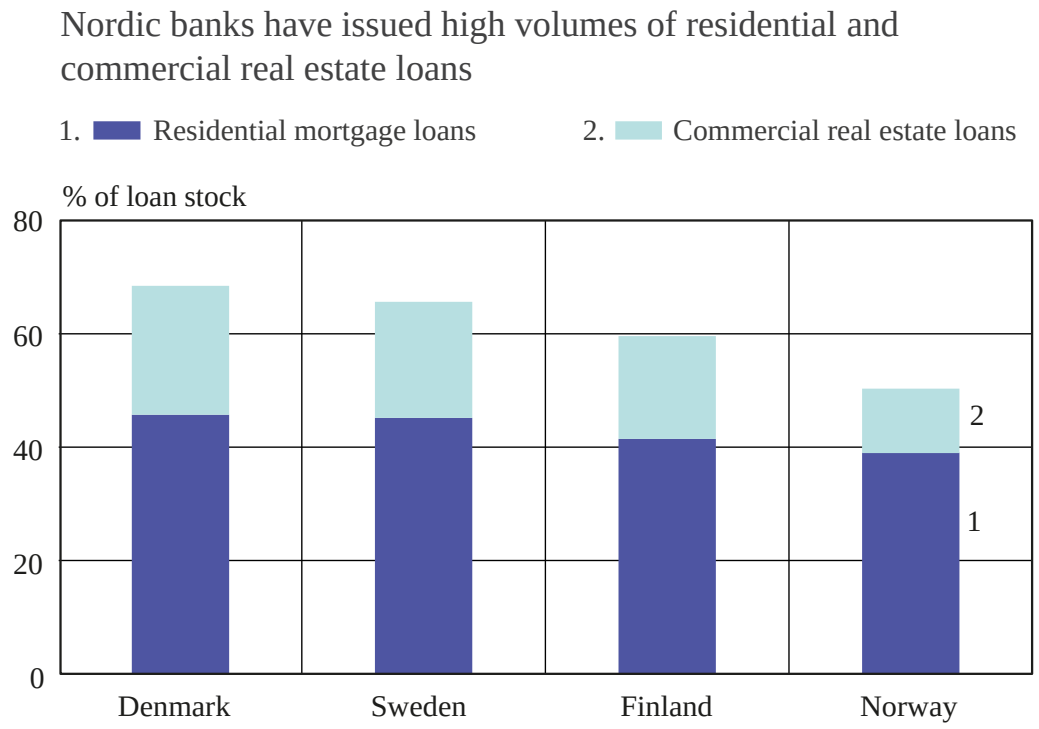
Risks on the residential and commercial property markets have played a role in the emergence and severity of many previous economic and financial crises. In times of sharply increasing indebtedness and a synchronous overheating of the real estate market, housing and property prices have risen in an unsustainable manner. Economic downturns following debt-driven price bubbles have been particularly deep and protracted.

The COVID-19 crisis has diverged significantly from previous economic crises in that it was triggered by an exogenous shock, i.e. a health threat coming from outside the economy. Moreover, the housing market sustained its strength in spite of the economic slowdown. In a situation where the economic outlook remains uncertain and may deteriorate suddenly again, there is a risk that vulnerabilities in the financial system could increase further.

Households and professional real estate investors finance a significant share of their residential and property transactions with debt. Housing loans and a large proportion of Nordic investors' debt financing are from domestic banks in the region. Property investment companies focusing on the management and rental of residential and commercial property also raise market funding by issuing bonds.

Housing loans and loans to firms in the real estate sector account for a large proportion of the provision of credit by Nordic banks. For this reason, these loans have a significant impact on the banks' credit risks. Data on large European banks collected by the European Banking Authority (EBA) shows that, at the end of 2020, the share of residential and commercial real estate loans in the stock of bank lending varied in the Nordic countries from almost 70% in Denmark to 50% in Norway (Chart 1).[3] Denmark and Sweden recorded the largest shares in Europe, while among the largest countries the share of these loans was only 28% in Germany and 17% in France, for example.

Chart 1.



Source: EBA.

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The scale of credit risks and losses depends on the payment ability of indebted households, investors and firms as well as changes in the value of the housing and property serving as loan collateral. Nordic banks' losses from housing loans and other real estate lending have been small in recent years. Low interest rates, payment holidays and substantial monetary and fiscal stimulus to support the economy have helped tenants and owners to stay solvent, which has facilitated debt repayment during the pandemic.

Some of the banks' own funding and investment activities are also closely linked to the housing market. Bonds collateralised by housing loans, i.e. covered bonds issued by banks, constitute a significant proportion of banks' long-term market-based funding. Banks also invest in covered bonds issued by each other and hold these investments in their liquidity buffers. In Sweden, for example, banks hold about 20% of all covered bonds issued by Swedish banks.

Pricing and demand for debt securities issued by Nordic banks depend on the confidence of international and domestic investors in banks and in their respective domestic residential and commercial real estate markets. If the risks on these markets were to materialise, this would drive

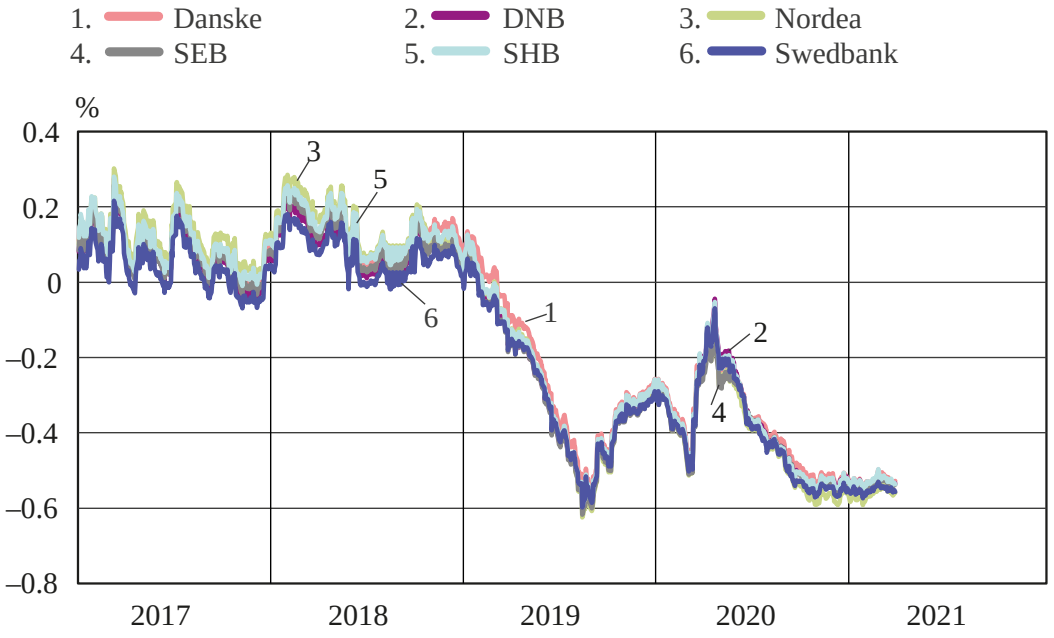
up the cost of bank funding which, in turn, could undermine bank lending capacity and tighten the credit standards for new loans to firms and households.

Nordic banks have long enjoyed good credit ratings, low funding costs and easy access to market funding. Bank funding costs increased temporarily after the outbreak of the pandemic, but the market recovered fairly rapidly (Chart 2). The yields required by investors have long been negative, indicating that bank bonds have been attractive to investors even during the pandemic.

Bank-specific differences in required yields are minor. This is partly because investors perceive Nordic banks as a very homogeneous group in the bond market, due to their similar strengths and vulnerabilities. This increases the contagion risk, i.e. disruptions on the financial markets and in the economy could easily spread from one bank or country to another.

Chart 2.

Yields on Nordic banks' covered bonds have returned to pre-pandemic levels



Covered bonds maturing in 2022.
Source: Bloomberg.

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Central banks' purchase programmes also support the demand for covered bonds of Finnish and

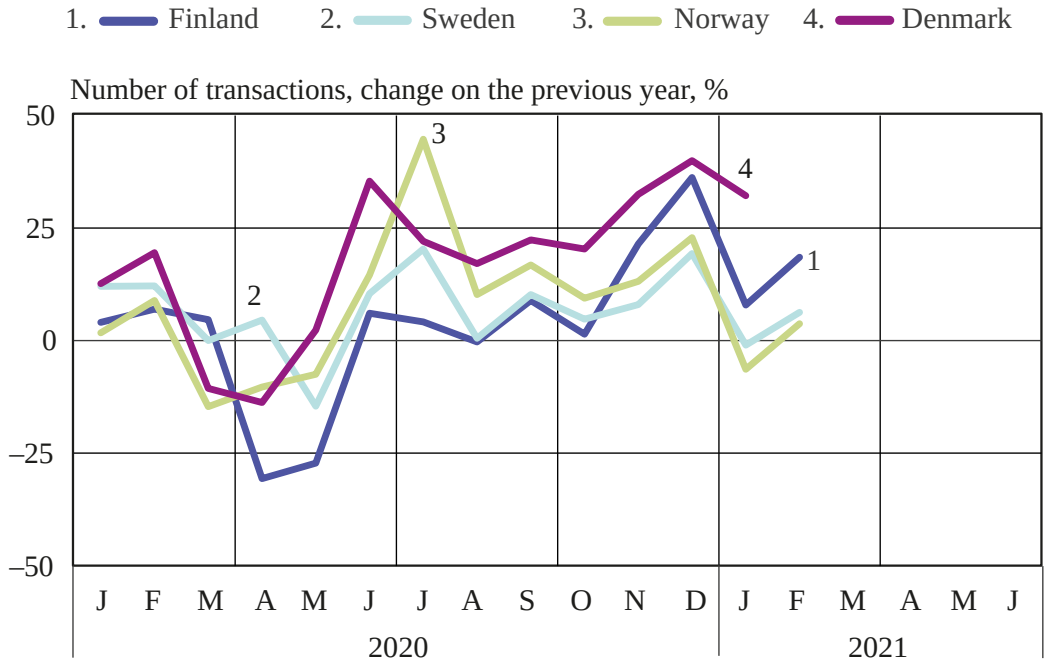
Swedish banks. Covered bonds were included in the ECB's purchase programmes for the first time in 2009. The Swedish Riksbank, in turn, launched purchases of Swedish krona-denominated covered bonds issued by domestic banks in March 2020 as part of its pandemic-related economic support measures.

Housing market recovered quickly from first wave of pandemic

Residential property transactions in the Nordic countries fell sharply in spring 2020, as the pandemic fuelled economic uncertainty, and lockdowns affected the activities of banks, real estate agents and their customers (Chart 3). Transaction activity started to recover in the summer, once consumer confidence in the economy improved and private home viewings and the use of digital services, for example, became more common. House sales increased further in the autumn and towards the end of the year, when pent-up demand accumulated during the spring was released into the market. As a whole, 2020 saw more house sales than the previous year, and 2021 also began at a brisk pace.[4]

Chart 3.

Nordic house sales quickly recovered from the first wave of the pandemic



Finland: old dwellings; Sweden, Denmark and Norway: all dwellings.
Sources: Central Federation of Finnish Real Estate Agencies, Mäklarstatistik, Statistics Denmark, Eiendom Norge, Macrobond and calculations by the Bank of Finland.

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There are many factors underlying the strong housing market dynamics. Urbanisation and low interest rates have long driven high demand for owner-occupied and investment housing in growth centres. Household and investor demand has also persisted during the pandemic, which has shortened sales times and reduced the number of homes available for sale. In Finland, for example, the number of online listings of homes for sale was lower at the end of 2020 than a year earlier. The supply of rental apartments, in turn, has increased.[5]

The economic repercussions of the pandemic have so far been less severe than anticipated in the Nordic countries. The Nordic economies contracted by about 3% in 2020, compared with a decline of nearly 7% for the euro area as a whole. Extensive fiscal stimulus has contributed to slowing unemployment growth, which has helped households to cope better with their financial obligations. Consumers' expectations concerning their own financial situation have also been

stronger than their confidence in the overall economy.

The economic fallout from the pandemic is estimated to have hit tenants harder via the labour market than owner-occupiers with housing debt. In Finland, for example, the number of young and elderly wage earners fell more because of the pandemic than the number of other wage earners.[6] Tenant households are most common among the young age groups, and households who have paid off their mortgages most common among the elderly age cohorts. The number of persons furloughed during the pandemic has been high in the construction, transport, restaurant, retail and tourism sectors.[7] These sectors entail more part-time and occasional work on average than other sectors – forms of work that are typical among young and the elderly people.

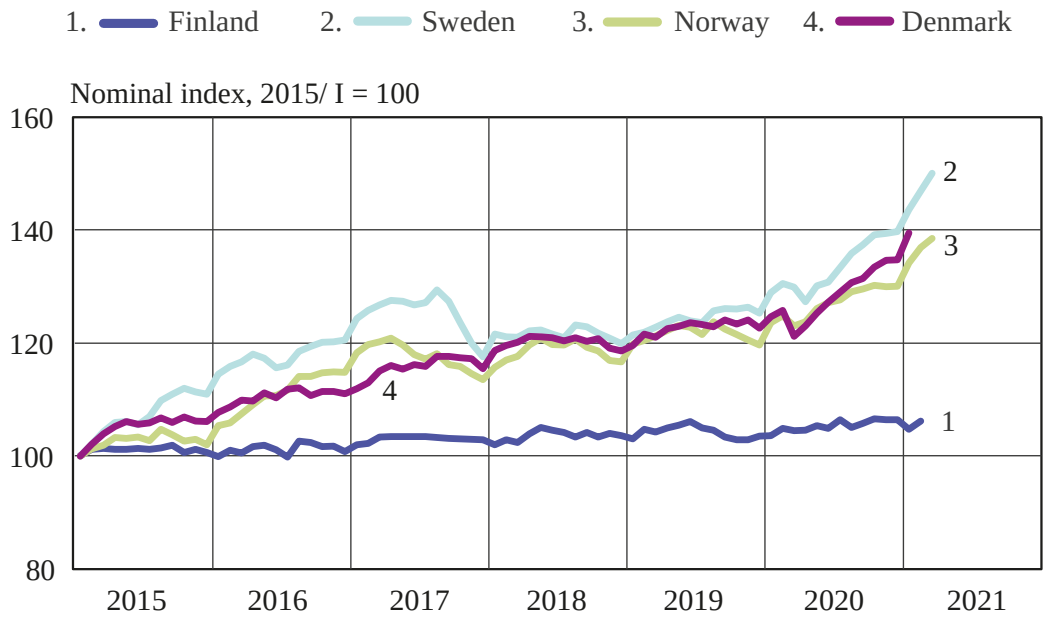
Low interest rates, mortgage payment holidays and relaxation of macroprudential policy have supported the economy and the housing market alike. At the end of June 2020, Finland raised the maximum loan-to-collateral ratio (LTC, loan cap) for homebuyers other than first-time homebuyers to its standard level of 90%. Finnish banks also generously granted payment holidays for their customers. In Norway, Norges Bank quickly lowered the policy rate from 1.5% to 0.25%. Norway and Sweden both relaxed their macroprudential requirements for mortgage borrowers during 2020.

The strength of house sales and new mortgage lending and the ample use of payment holidays have fuelled growth in the stock of housing loans and household indebtedness. The stock of housing loans has long expanded rapidly in Norway and Sweden, while the pace has been slower for Finland and Denmark. Nordic households have high debt levels relative to income and their indebtedness has increased in recent years, with the exception of Denmark, where household indebtedness is nevertheless the highest among the Nordic countries.

The rise in house prices accelerated in the Nordic countries towards the end of 2020 and the trend continued in early 2021, most notably in Norway and Sweden (Chart 4). This was not exceptional on a European scale, however, as in 2020 house prices also rose widely across Central and Southern Europe. On the other hand, rising house prices combined with high household indebtedness will amplify the vulnerabilities associated with mortgage lending, especially for banks in the Nordic countries.

Chart 4.

House prices increasing at a faster pace in Sweden, Norway and Denmark



Finland: old dwellings; Sweden, Denmark and Norway: all dwellings.
Sources: Statistics Finland, Valueguard, Statistics Denmark, Eiendom Norge, Macrobond and calculations by the Bank of Finland.

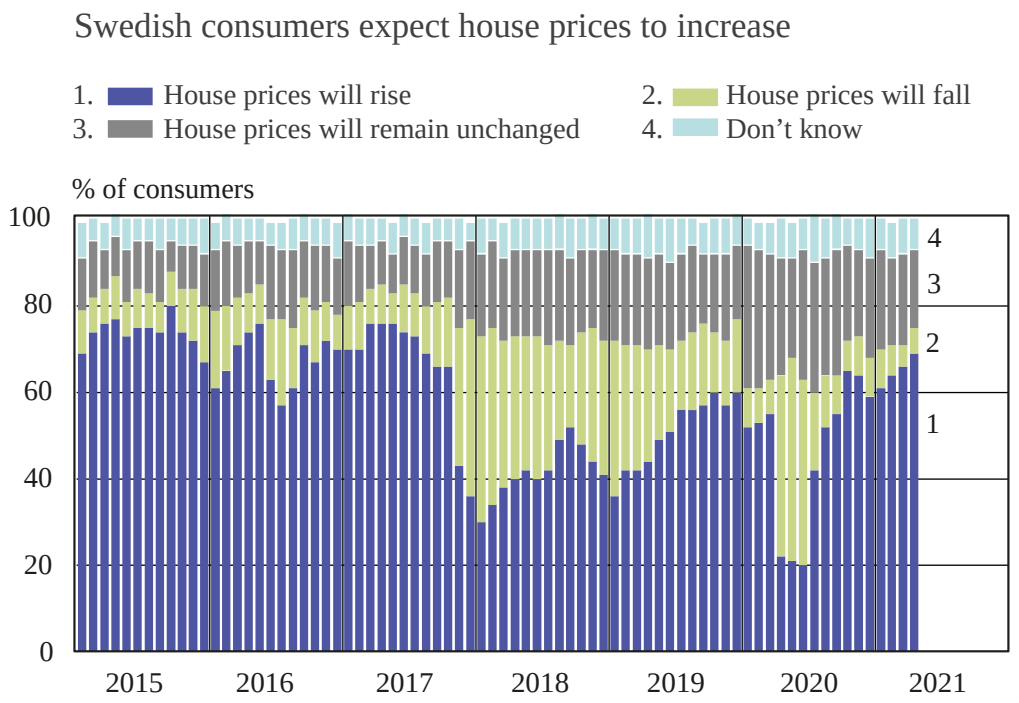
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In the short term, the housing market is facing risks in both directions. On the one hand, housing market activity may remain brisk or strengthen further on the back of favourable financing conditions. In this case, there is a risk that the housing market could become overheated in regions where housing demand clearly exceeds supply. On the other hand, if the economy recovers more slowly than expected and bankruptcies and unemployment increase, debt-servicing difficulties may worsen and the risks of weaker-than-expected economic developments may also materialise on the housing market.

The vast majority of Swedish consumers expect house prices to increase further over the next 12 months (Chart 5). This may strengthen housing demand and thus drive up prices, since the number of dwellings will not increase with demand – at least not in the short term. A rapid rise in house prices may fuel excessive indebtedness and risk-taking, amplifying the risk of house price deflation

over the longer term. In the past, house prices have fallen when rising interest rates or declining income has boosted households' and investors' debt-servicing burdens and stepped up forced sales.

Chart 5.



Consumer expectations over the next 12 months.
Sources: Macrobond and SEB.

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Real estate investment market has not yet suffered significantly from the pandemic

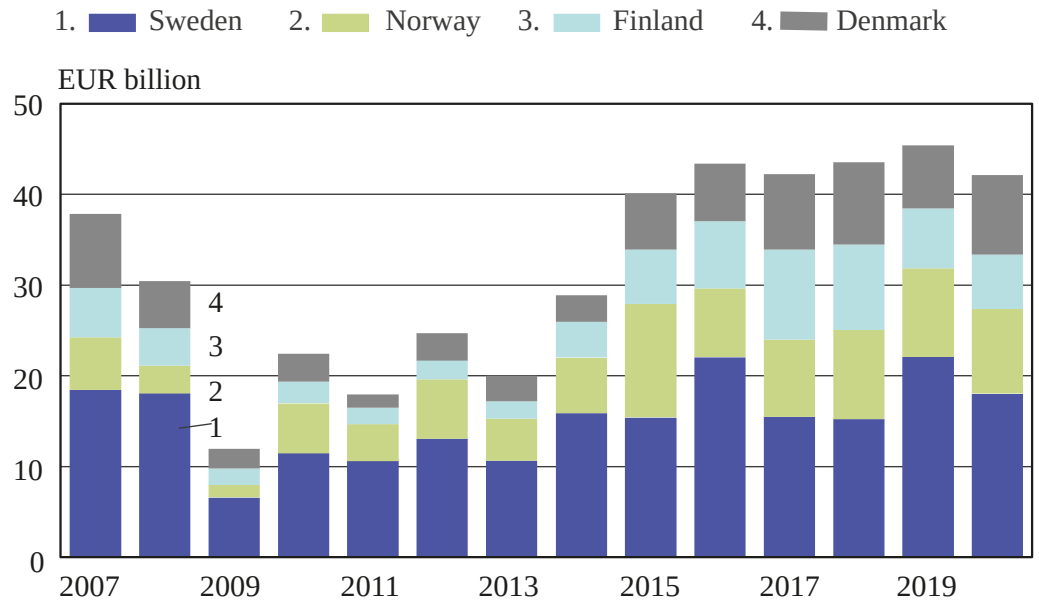
The commercial property market is vulnerable to economic downturns, as empty premises and rental losses depress real estate investors' income. Typical real estate investors in the Nordics are, for example, large domestic institutions such as insurance and pension companies, and domestic and foreign property investment companies[8] and funds. Difficulties experienced by property investment companies investing with high leverage could be reflected in the growth of banks' non-performing loans and credit losses. Borrowers could also face problems in accessing new funding from banks and the bond market.[9]

Banks' risks associated with lending to property investment activities have received attention over the recent years, most notably in Sweden and Norway. In both countries, banks' commercial real estate exposures are subject to a risk weight floor[10] of 35%, which is to ensure that banks have sufficient capital buffers to cover potential future credit losses from real estate lending.

Activity on the Nordic property investment market slowed down after the outbreak of the pandemic but picked up notably towards the end of 2020. According to data by Pangea Property Partners, which monitors the Nordic real estate investment market, the total volume of transactions in 2020 was only slightly behind the volume in 2019 (Chart 6). Moreover, the rents of high street offices in capital cities did not fall extensively. However, the pandemic has likely prompted many lessors to grant temporary rent reductions to their customers.

Chart 6.

Strong year-end brought the volume of commercial property transactions in 2020 close to the previous year's level



Source: Pangea Property Partners / Mrec.

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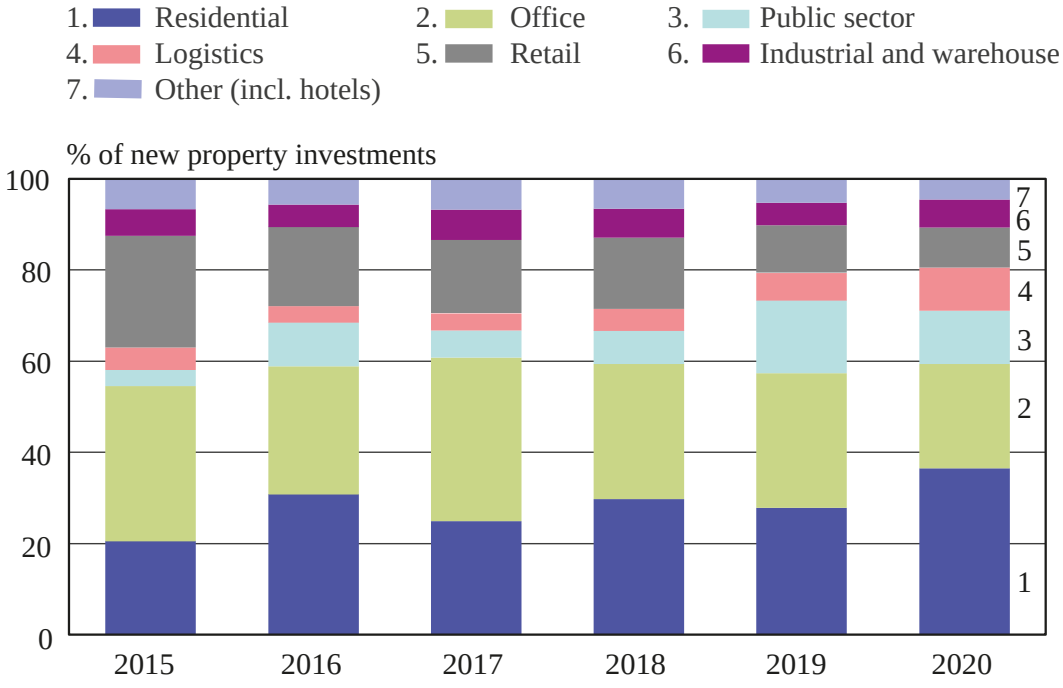
Residential property accounts for a significant proportion of Nordic property investors' portfolios. Of the transactions concluded in 2020, residentials was once again the largest property segment in value terms (Chart 7). The weight of office, retail and public properties decreased, while the

share of logistics property in the value of transactions increased. These changes in the shares of different sectors reflect long-term trends on the property investment market.

The pandemic period has also intensified pre-existing trends. The increase in remote working reduces the need for offices and may fuel the conversion of office buildings to residential use. Retail property returns are suffering from the restrictions on mobility and the growing popularity of online purchases. On the other hand, growth in online shopping has increased the importance of the logistics sector. Hotel properties have long accounted for a small proportion (less than 5%) of all property transactions in the Nordics, and a further decrease was evident in 2020.

Chart 7.

Residential property the largest sector in the property investment market in 2020



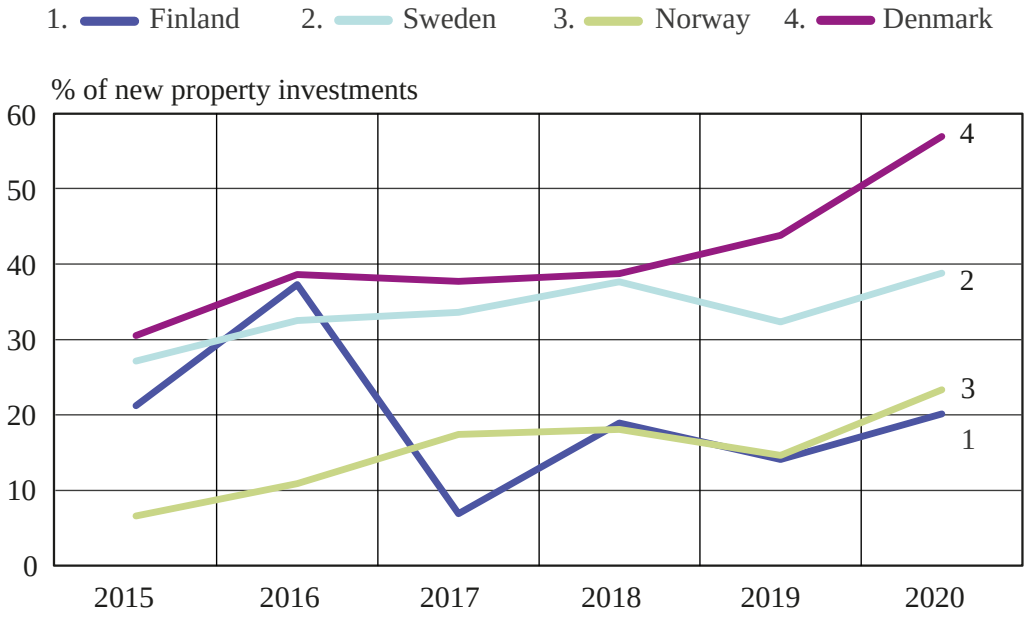
Source: Pangea Property Partners / Mrec.

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The share of residential property in total property transactions grew in all the Nordic countries during 2020 (Chart 8). Many lessors have granted rent relief, for example to restaurants due to restrictions on opening hours, and residential property appears to have offered the most stable income flows to real estate investors. Not surprisingly, in 2020 the largest individual real estate transactions in the Nordics concerned residential property.

Chart 8.

Share of residential property in new property investment grew in 2020 in all the Nordics



Source: Pangea Property Partners / Mrec.

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Notes

1. See https://www.bofbulletin.fi/en/2020/2/nordic-countries-are-vulnerable-to-housing-market-risks-aggravated-by-the-coronavirus-pandemic/. For more detailed information, see also ESRB (2019) Vulnerabilities in the residential real estate sectors of the EEA countries. ↑
2. See https://www.bofbulletin.fi/en/2018/articles/risks-on-the-swedish-housing-market-also-a-cause-for-concern-in-other-nordic-countries/. ↑
3. Loans to the construction sector are excluded. They account for a larger share of corporate loans in Norway than in Finland, Sweden or Denmark. ↑
4. Epidemics have also caused short-term disturbances on the housing market before. Due to the SARS epidemic, for example, house sales temporarily dipped dramatically in 2003, most notably in Hong Kong, but the recovery was swift and the impact on house prices remained modest. See Wong, G. (2008) Has SARS infected the property market? Evidence from Hong Kong. Journal of Urban Economics, Volume 63, Issue 1, 74–95. ↑

5. See https://www.stat.fi/tup/kokeelliset-tilastot/asuntojen-myynti-ja-vuokrailmoitukset/2021-01/index.html and https://www.etuovi.com/asuntojen-hinnat-ja-asuntomarkkinat (both in Finnish). ↑
6. See https://www.stat.fi/tup/kokeelliset-tilastot/tulorekisterin_palkat_ja_palkkiot/2020-joulukuu/index.html (in Finnish). ↑
7. See https://tem.fi/koronaviruksen-vaikutukset-tyollisyystilanteeseen (in Finnish). ↑
8. In Finland, large real estate investment companies include Kojamo, Sato and Citycon. ↑
9. In Sweden, the number of property investment companies is high and the firms also use market funding fairly actively: about two thirds of their debt financing is from banks and one third from bond markets. Some Swedish companies also issue bonds denominated in euro. ↑
10. In calculating banks' capital adequacy, bank exposures are subject to risk weight floors. The higher a loan's risk weight is, the more own funds a bank must have to cover the credit risk related to the loan. The risk weight floor sets a lower limit for the risk weights of certain types of loans. ↑

Keywords

banks, COVID-19, housing markets, Nordic countries, property investments