MORTGAGES IN EUROPE

UNDERLYING TRENDS IN 2004 – 2006

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Basic facts

- Mortgage loans (MLs) in the EU25 countries had a total value of EUR 4.7 trillion.
- Total mortgage loans as a share of the EU's gross domestic product represent 45%, or EUR 10,000 per capita in the EU.
- Net mortgage lending in 2004 amounted to EUR 412 billion.
- While GDP increased by 2.3%, the mortgage market grew by 9.7% to exceed the previous year's rise by 2.3% and the average growth by 1.2%.
- The United Kingdom has Europe's largest mortgage market – mortgage loans in circulation = EUR 1.2 trillion, or a quarter of the European market; the smallest market is in Slovenia.
- Prices of residential real estate increased most sharply in Malta (18.8%), France (17.6%), and Spain (17,5). In Belgium, Denmark, Ireland, and the United Kingdom, the growth in property prices fluctuated at around 11%. By contrast, Germany and Austria recorded price declines.
- Mortgage interest rates almost halved between 1996 and 2004.
- The number of flats per 1,000 inhabitants is 434 in the EU25, 457 in the EU15, and 399 in Central and Eastern European countries.
- Deposits continue to be the main source of funding. The importance of other sources – mortgage bonds or mortgage-backed securities (MBS) is gradually increasing.

Mortgage markets in 2004

In 2004, economic growth fluctuated at around 2.3% with considerable variation from country to country. The highest growth was reported in the new EU Member States – Latvia had 8.4%, Estonia 7.8%, and Lithuania 7.8%, followed by Poland with 5.6% and Slovakia 5.5%.

For the years 2003 and 2004, inflation remained at 2.1% in the euro area, and ranged between 3–4% in the new Member States. The highest inflation rates of between 6–7% were reported in Latvia, Hungary, and Slovakia, and the lowest, at around 1%, were in Lithuania, Denmark, Finland, Sweden and the United Kingdom. The rate of unemployment in the EU remained unchanged at 9 per cent.

In 2003, housing mortgage loans increased from EUR 4.2 billion to EUR 4.7 billion at the end of the year, or by 9.7%. The average rate of growth for the previous five years stood at 8.5%. The rise in mortgage lending was supported by low interest rates, new mortgage products, and competition. In the EU15, the fastest developing markets are in Ireland, Greece, and Spain. The rate of growth among the new Member States exceeded 50% per year. These markets are relatively young and their economic growth is comparatively high, which all contributes to development of the mortgage market.

The United Kingdom can be considered to have the largest mortgage lending market, which being worth EUR 1.2 trillion represents a quarter of the European market. Slovenia has the smallest mortgage lending market – at around EUR 387 million. The differences between markets are reflected in the mortgage debt to GDP ratio. The average ratio for the EU is 45.3%, where the Netherlands has the highest figure and Slovenia the lowest. In the Netherlands, the tax settlement for mortgage interest supports the stability of this ratio, whereas in Slovenia, the low ratio is determined by the size of the market and its underdevelopment. Despite the substantial differences, the mortgage debt/GDP ratio increased in all the Member States.

Mortgage lending increased mainly as a result of the decline in interest rates. According to data from the European Mortgage Federation, interest rates fell by half over the period 1994–2004. In the euro area they are at a low level – an average of 4.41% at the end of 2004. Interest rates also came down in the new Member States, and the average level in 2004 fluctuated between 7–8%.

EU real estate market

The number of flats per 1,000 inhabitants is 434 in the EU25, 457 in the EU 15, and 399 in Central and Eastern European countries. Sweden, Austria, and Greece have the highest number of flats per 1,000 inhabitants.

The supply of flats in the EU increased in 2004, although the growth varied from country to country. The construction of new flats rose most quickly in Ireland and Spain, where the number of flats completed per 1,000 inhabitants represented 19.1 and 11.7 respectively; among the other countries, this ratio ranged between 2 and 6 completed flats per 1,000 inhabitants, and for the new Member States the figure was 2. Trends in the issuance of building permits were very similar.

The average rate of flat ownership in the EU is 64%. The rate is higher in the southern and new Member States (more than 80%). The strong growth in flat prices is caused largely by surplus demand. Several countries saw real estate prices post double-digit rises, including Malta (18.8%), France (17.6%), and Spain (17.5%). Significant price increases of around 11% were also reported in Denmark, Belgium, Ireland, and the United Kingdom. In Germany and Austria, by contrast, real estate prices declined (by 0.8% in Germany and around 6% in Austria).

Although data on real estate prices are not available for all central and east European countries, it is estimated that they are increasing sharply. Property prices in 2004 rose for example, in Slovenia and Poland by 12% and 10% respectively, while the increase in Slovakia is put at 10 – 15%.

In some countries, real estate prices in 2004 increased only slightly in comparison with 2003 – in the United Kingdom, for example, the rise was less than 5%.

The market in the EU and USA

In 2004, current mortgage loans in the United States amounted to EUR 6.2. trillion. Housing mortgages increased by 13.6%, or an average of 11% within 5 years.

The mortgage debt/GDP ratio is higher than in the EU, and in 2004 it represented 64.5% (EU 45.3%). Real estate prices in that year increased, as they did in the EU, with a spread from 28.1% (Nevada) to 4.7% (Texas). According to the latest evaluations of the mortgage market by the Mortgage Bankers Association (USA), the higher growth in the market was stimulated by an increase in employment and by growth in households and incomes. The same cannot be said about the EU market. The workforce is less mobile and the labour market is less flexible. In European countries with favourable macroeconomic trends there are also positive outlooks for the mortgage lending market.

Mortgage loan funding

In the EU, deposits are the largest source of mortgage funding, followed by secondary financial sources – mortgage bonds. According to figures from the European Mortgage Federation, mortgage bonds in the EU have a total value of EUR 794.267 million, which accounts for 17% of mortgage loan financing. The largest markets in mortgage bonds are in Germany (EUR 249,848 million), Denmark (EUR 232,799 million), Spain (EUR 94,707 million) and Sweden (EUR 82,493 million). Mortgage bonds are a particularly significant source of funding in Denmark, Hungary, Sweden, and the Czech Republic.

Mortgage-backed securities (MBSs) are at present issued in 4 countries: the United Kingdom, Spain, the Netherlands, and Italy. The value of issued MBSs recorded a sharp rise of 10.2% in 2004, from 125.6 billion in 2003 to 138.5 billion.

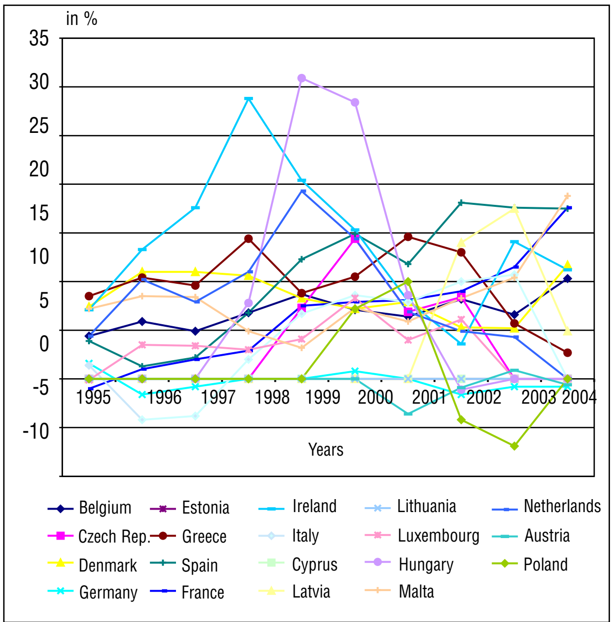
Although deposits continue to be the main source of mortgage financing, their share has declined in recent years and alternative sources of financing have an increasing weight. Creditors are to an increasing extent diversifying their mortgage financing strategies.

Table 1 Mortgage bonds in circulation as a percentage of mortgage debt

Country	%
Denmark	100.0
Hungary	63.0
Sweden	56.0
Czech Republic	29.0
Spain	25.0
Germany	21.5
France	15.0
Austria	6.0
EU	17.0

Source: European Mortgage Federation (EMF), 2005.

Chart 1 Mortgage debt/GDP



Trends in the mortgage markets and real estate markets in 2005

Mortgage loans

Mortgage lending in EU countries continued to increase, with the annual rate of growth fluctuating at around 10%. Among the new Member States, the strongest market growth was reported in Latvia (90%), Lithuania (90%), and Estonia (more than 70%); as for the EU15, the highest increases were in France, Denmark, Portugal, the United Kingdom, and Spain (around 10%). In France, the government expanded mortgage lending by setting a 0% rate of interest on the acquisition of seasonal or weekend homes (flats). In both Denmark and Spain the growth in mortgage lending is supported by low interest rates. Denmark, for example, reported gross mortgage lending at EUR 90,000 million and net mortgage lending at EUR 20,000 million. The ratio of net mortgage lending to gross mortgage lending reflects the level of mortgage financing in the given country, with the principle being that the lower the ratio, the higher the level of financing. The low ratio in Germany is related mainly to the low value of net mortgage lending vis-_-vis the repayment or early repayment of loans. Whereas the market in the United Kingdom declined slightly in 2005, lending activity in Greece recorded a notable rise in the last quarter of the year, while in Italy the market doubled between 1999 and 2005 and increased by 18% in 2005.

Mortgage interest rates

Interest rates in the fourth quarter of 2005 remained relatively unchanged. At the aggregated level, short-term interest rates (calculated on a quarterly basis) for the purchase of real estate rose slightly, whereas long-term rates fell. Individual monthly mortgage rates, both short-term and long-term, increased in November and December 2005 and in January 2006. The November uptick stemmed from the ECB's intention to put up base rates. After the ECB raised repo rates in December 2005, mortgage rates followed suit in January 2006. The increase in mortgage rates is also confirmed by the EMF's data. In the last quarter of 2005, interest rates rose in several Member States. Those with a fixed rate for 1 to 5 years went up in Germany, Denmark, Spain, Ireland, and Sweden. The increases ranged from 9 to 65 percentage points.

Price developments

Real estate prices in Europe remain mixed, reflecting the variety of both mortgage lending markets and markets in flats. Denmark and Latvia reported the highest increase in prices for residential units, 25.7% and

Table 2 Annual percentage change in prices of residential units 1994 – 2004

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Belgium	4.40%	5,90%	4,90%	6,80%	8,70%	7,10%	6,40%	8,20%	6,60%	10,30%
Czech Republic	n/a	n/a	n/a	n/a	7.30%	14.40%	6.90%	8.40%	n/a	n/a
Denmark	7.40%	11.00%	11.00%	10.60%	8.30%	7.20%	7.90%	5.30%	5.20%	11.70%
Germany	1.60%	-1.60%	-0.80%	0.00%	0.00%	0.80%	0.00%	-1.60%	-0.80%	-0.80%
Estonia	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Greece	8.50%	10.40%	9.60%	14.40%	8.80%	10.50%	14.60%	13.00%	5.70%	2.70%
Spain	3.90%	1.30%	2.20%	6.80%	12.30%	14.90%	11.80%	18.10%	17.60%	17.50%
France	-1.00%	1.00%	2.00%	2.90%	7.50%	7.90%	8.10%	9.00%	11.50%	17.60%
Ireland	7.10%	13.30%	17.60%	28.80%	20.40%	15.30%	8.00%	3.60%	14.10%	11.20%
Italy	1.40%	-4.20%	-3.80%	2.00%	6.70%	8.60%	7.90%	10.00%	10.70%	n/a
Cyprus	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Latvia	n/a	n/a	n/a	n/a	n/a	n/a	n/a	14.00%	17.50%	4.90%
Lithuania	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Luxembourg	-0.10%	3.50%	3.40%	3.00%	4.10%	8.30%	4.00%	6.10%	n/a	n/a
Hungary	n/a	n/a	n/a	7.80%	30.90%	28.40%	8.60%	-1.10%	n/a	n/a
Malta	7.20%	8.50%	8.40%	4.90%	3.20%	7.30%	5.90%	8.30%	10.40%	18.80%
Netherlands	4.40%	10.20%	7.90%	11.00%	19.30%	14.40%	6.90%	4.90%	4.30%	n/a
Austria	n/a	n/a	n/a	n/a	n/a	n/a	-3.60%	-0.90%	0.90%	-0.60%
Poland	n/a	n/a	n/a	n/a	n/a	7.20%	10.00%	-4.20%	-6.90%	n/a

Source: EMF, Hypostat.
Notes:
Belgium – average prices of existing residences;
Denmark, Spain, France – only second residential units (seasonal, weekend);
Greece, Italy – only urban areas;
Ireland – average prices of all residential real estate financed by mortgages;
Sweden – one- and two-flat dwellings;
UK – prices of all residential units.

25.8%, respectively; there was also price growth in Sweden (around 10%), Finland (6.4%) and Ireland (11.3%). In Spain, prices rose more slowly in 2005, by 13.2% in comparison with 18% in 2003. Meanwhile prices in the UK went up a mere 3.4% in the third quarter of 2005 and 2% in the last quarter; prices rose again in the first months of 2006, by around 5%.

Trends expected for 2006

In December 2005, the ECB raised key interest rates by 25 basis points, and the expectation in 2006 is for further increases. The effect on interest rates varies from country to country depending on whether variable or fixed rates are typical and on the amount of debt.

In Ireland, the mortgage market is expected to expand with the support of sustainable growth in incomes, demographic developments, and new products. The high confidence in real estate investments will offset higher mortgage rates. According to the central bank, new mortgage lending in 2006 will probably exceed 22 billion, representing an increase of 10% in comparison with 2005.

In Spain, interest rates are not expected to rise sharply. The mortgage lending market will absorb the increase in construction recorded in 2003/2004, and real estate prices will rise moderately by around 5% up to the end of 2006. In Greece, the lending market is expected to expand by around 25%. Denmark will see a slowdown in the market with mortgage rates having been raised by around 50 basis points. Gross mortgage lending in the UK will hit GBP 275 billion by the end of the year, while net mortgage lending will decline from GDP 90 billion to GDP 75 billion in 2006. Despite the decline in net mortgage lending, mortgage debt will increase more sharply than household income. In Germany, the market is expected to recover provided that employment and real incomes increase.

Real estate valuation perspectives

The valuation of real estate for mortgage lending purposes is carried out in many different ways within the EU, depending on the country in question and on the received philosophy in property valuation. The basis is the "mortgage lending value" or market value. The mortgage lending value represents the long-term sustainable value of a property, the level of which is set by the credit institution. The mortgage lending value is used in both the mortgage lending and risk management processes. Inasmuch as the mortgage lending value reflects the long-term value of a property, it cannot be compared with the market value set at a given date (the "immediate market value"). All international valuation methods use the mortgage lending value while also having regard to the type of property, market specifics, and locality. The long-term applicability of the mortgage lending value requires compliance with certain measures aimed at the elimination of short-term market volatility or temporary market trends. In setting the market lending value, appraisers must take into account the following basic factors:

- Future marketability – the marketability of the property must be valued carefully and cautiously in regard to the long term.
- Consideration must be given to those features of the property that are sustainable over the long term, such as the quality of its location, the quality of the building and of the materials used in its construction, the building's bearing area, etc.
- As regards determining the sustainable income, the rental income needs to be calculated on the basis of past and current long-term market trends; any uncertain components of potential future income should not be factored in.
- The rate of capitalization is also based on long-term market trends and it excludes all short-term expectations concerning investment returns.
- Where the mortgage lending value is stipulated on the basis of comparative values or the write-off of costs, the sustainability of the comparative values will be taken into account through the application of discounting (as required).
- The mortgage lending value is set on the assumption that the property will be used in a standard way; in certain cases, it is based on alternative utilization, for example, where there are plans to renovate the property or to change its use.
- Other requirements – for example, compliance with national standards, transparency, the content and comprehensibility of the valuation, the supplementary legal framework for the calculation of mortgage lending value.

Although the mortgage lending value has much in common with the market value, there are several clearly identifiable differences. The market value of a property is set at a given time. It represents the price obtainable for the property within a short period of time and it may change very quickly. By contrast, the mortgage lending value represents the long-term sustainable value of a property offered as security for a mortgage loan, regardless of future market fluctuations. Set on a relatively stable basis, it is usually lower than the market value, and this creates room to absorb short-term market fluctuations.

Some countries have built up a "strong" regulatory framework (with both evaluation standards for real estate and standards for appraisers); in other countries, there is a self-regulatory approach to valuation or no regulation at all. It should be added, however, that some European countries have begun testing more sophisticated models – automated valuation models – which take into account and allow for human factor interventions. Despite the variety of valuation systems, it is evident that they also have common aspects. The valuation methods are more or less the same. Real estate rents are valued using yield (capitalization) methods, while owner-occupied residential units (whether flats or family houses) are valued by means of comparative methods, etc.

In certain areas of real estate valuation, a higher degree of integration and a better quality of price-setting could be achieved. This applies, for example, to valuation indicators such as the built-up and floored area (gross, residential), which are used differently in calculations. Another example is provided by the operational costs calculated when determining the income from a valued property. A practical guide to the setting of property prices will address matters such as the definition of prices, the qualification of appraisers, and general risk criteria.

Risk profile related to valuation criteria

The risk profile may be used by creditors as additional information to support the identification and management of risks. The profile should increase the quality of valuation from the view of mortgage lenders.

The risk profile is being created on the basis of the conclusions drawn from a comparative study: "The Valuation of Property for Lending Purposes in the European Union". The valuation of real estate is considered to be a basic criterion for the optimal measuring and managing of the credit risk to mortgage lenders, in accordance with a risk-sensitive approach to capital adequacy measures. The prudent valuation of collateral real estate is one of the areas of this legislation.

The risk profile is a tool in the management and reduction of risk. It should help to improve both the quality and trustworthiness of valuations.

The valuation of property for lending purposes reflects the following risk criteria:

Market risks
- Timing (current market conditions)
- Market cycle
- Market volatility/stability/liquidity
- Demand and supply
- Market structure
- Attractiveness of regional markets
- Investors' market and owners' market
- Behaviour of market participants
- Demographic trends
- Work supply
- Other investment opportunities

Local risks
- Planning and development of neighbouring areas (micro a macro)
- Development of regions, towns and districts
- Competition: micro – trends in the local economy/other alternative investment opportunities at the local level
- The locality's suitability for investments, revenues, and growth in real estate value
- Infrastructure
- Local supply
- Attractiveness of the locality to companies
- Risk concentration (high percentage of secured properties in the same locality)

Real estate (building) risks
- Physical/architectonic quality of the property
- Maintenance requirements
- Marketability and flexibility of use
- Land contamination, pollution
- Reconstruction costs

Tenants/leasing
- Position of tenants
- Reputation of tenants
- Cash flow risk
- Local tax regime

Fiscal risks
- Standard tax conditions
- Potential positive/negative changes
- Local tax regime

Legal risks
- Ownership
- Permission
- Specific rent structure
- Subsidies

vEffectiveness of ownership changes