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Economic policy positions

The housing market in Germany: Corona and the consequences

Berlin, September 2020

Summary

→ **The prices for residential real estate continued to rise in the first half of 2020 despite the coronavirus pandemic and contrary to expectations.**

→ **The way the real estate market shapes up going forward will depend decisively on the shape of the economic recovery. Moreover, changes in living preferences could influence prices in the future.**

→ **According to current knowledge, there are no risks to financial stability. Macroprudential easing has not affected this resilience. Therefore, a tightening of macroprudential regulation should be avoided until at least the end of 2021.**

1. The situation on the housing market

Housing shortages in many cities, rising rents and even stronger increases in purchase prices - that was the situation on the German housing market before the coronavirus pandemic led to a historic economic slump in this country, as it did almost everywhere else in the world. Since the way the German housing market has shaped up over the past few years has been due not only to extremely low interest rates, but also to a large extent to the auspicious economic situation, the key question from the very outset of the Covid-19 crisis onwards was what consequences the pandemic would have for the real estate sector. Expert opinions ranged from the horror scenario of a "bursting bubble" to the argument that real estate offers a "safe haven" in a crisis. It is true that a price bubble can only burst if it exists. However, whether it (has) existed can only be determined with certainty ex post when the price collapse has actually occurred.

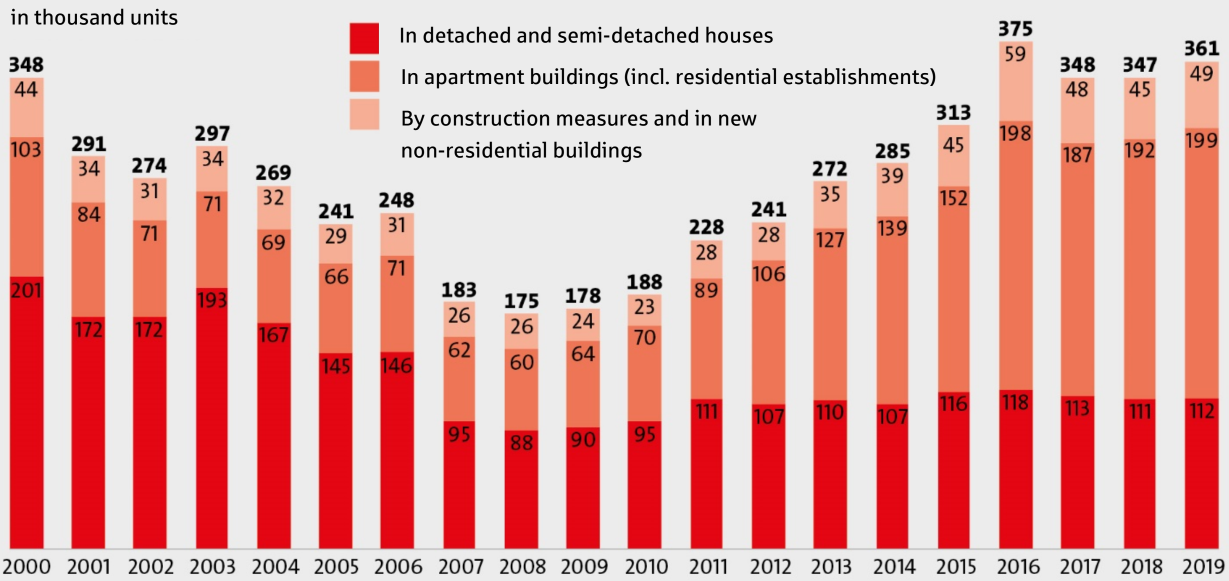
First and foremost, the rise in real estate prices in Germany is simply a consequence of scarcity - in other words, of the fact that demand for living space has grown faster than supply in many regions. It therefore makes sense to cast more light on both these determinants in the following analysis.

2. Demand for housing and building materials

For demographic reasons, demand for housing units has risen continuously in recent years. Labor migration, especially from Southern and Eastern Europe, and the influx of refugees has led to a nationwide increase in the population of Germany. In the conurbations, internal migration from rural regions and the growing number of single households have further stoked demand.

The Cologne-based think-tank German Economic Institute (IW) calculated that there would be notional new construction requirements of almost 342,000 housing units per year between 2016 and 2020; in the following years up to 2025, however, only 260,000 new homes would be needed annually. With its current calculation of demand (311,000 additional residential units each for the years 2019 and 2020, 271,000 for 2021 and 2022, and 242,000 for 2023 to 2026), the real estate research institute empirica arrives at a similar order of magnitude.

Development of Building Permits for Apartments in Germany



Source: Statistical Office of the Federal Government

3. Housing supply and construction activity

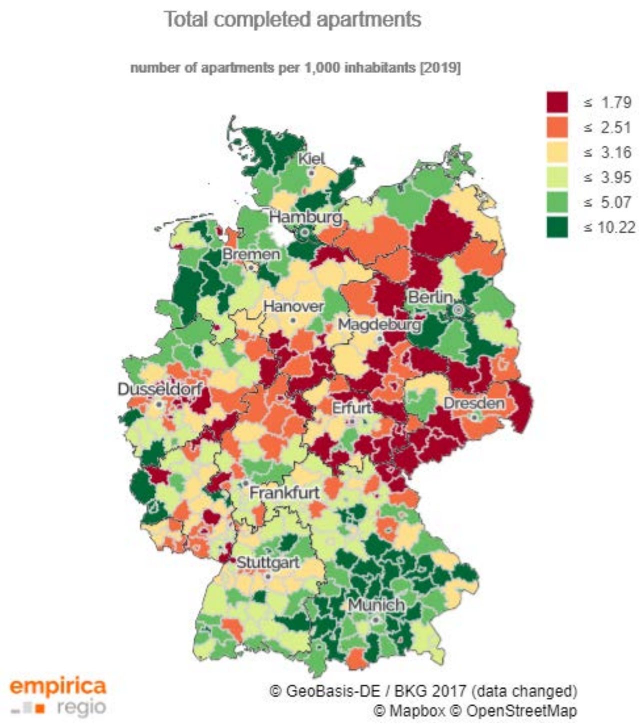
Building permits: The long-term trend in residential building permits is pointing sharply upwards: since 2011, the number of building permits has been on the rise again, and in the past five years it has even been well over 300,000 (chart). In 2019 the building authorities gave the green light for as many as 361,000 housing units - an increase of 4 percent over the previous year. This increase is largely attributable to multi-family housing units. Last year, almost 200,000 multi-story housing units were approved - a good three times as many as ten years earlier. The number of approved housing units in single and two-family houses has invariably been at a level of around 110,000 for nine years now. Recently, more and more housing units have been planned and approved through extensions, conversions and in non-residential buildings.

Although the first half of 2020 was overshadowed by the coronavirus pandemic, the trend in building permits in H1 2020 was not visibly affected by the crisis: in fact, a good 176,000 residential units were approved in the period from January to June this year, 7 percent more than in the same period last year. The fact that the increase in June was even a shade over 22 percent compared to the same month last year has nevertheless been identified by the Federal Statistical Office as a lockdown-related catch-up effect. In its construction trend forecast for 2020 as a whole, the Munich-based ifo Institute expects around 340,000 approvals, i.e. stabilisation at an appropriately high level.

Building overhang: However, an approved apartment is not yet ready for occupancy. The average time taken to complete construction projects in multi-storey residential construction has been slightly over two years. In 2020, the construction industry is therefore likely to be largely occupied with building those housing units for which the green light had already been given by the authorities in 2018. It is therefore no wonder that the problem which the Federal Statistical Office refers to as a construction logjam is not getting any smaller: At the end of 2019, a cumulative total of almost three-quarters of a million approved housing units were awaiting completion. The main reason for the further increase in the construction backlog is capacity bottlenecks in the construction industry.

Housing unit completions: Nevertheless, the fact that not only the number of building permits but also the number of housing units completed each year is constantly increasing is helping to relax the situation. In 2019, a total of 293,000 new housing units came onto the market - almost twice as many as in 2009 and a good 2 percent more than in the previous year. The 2020 completion forecast from the ifo Institute is 275,000 residential units.

That there is now noticeable progress in many sought-after cities is made clear by taking a look at district level. The fact is that a number of conurbations with brisk construction activity stand out on the map of Germany (chart): Hamburg, Berlin, Frankfurt, Munich and their environs accounted for 5 to 6 new housing units per 1,000 inhabitants in 2019, clearly



Source: Federal and Regional statistical offices / empirica regio

exceeding the national average of 3.5. In Cologne and Stuttgart, on the other hand, new construction continues to weaken, with only two new housing units completed per 1,000 inhabitants.

Overall, construction activity in Germany is thus continuing to converge with estimated demand for additional housing, but a gap still remains. Even by European standards, construction activity in Germany is by no means excessive (chart). According to the ifo forecast, Germany will only create around 3.7 new housing units per 1,000 inhabitants in 2020. In Finland, Austria, France and Switzerland, the figure is 6 in each case, and over 5 in Sweden, Poland and Denmark. Only the three southern European countries that were once crisis-ridden, Spain, Italy and Portugal, are currently somewhat more reluctant to build.

4. The price development of residential real estate: What effect is the coronavirus pandemic having?

In 2019, the now familiar picture of price trends in the residential real estate market remained unchanged. On a ten-year comparison, purchase prices have continued to outstrip rents: according to calculations by the Bundesbank based on data from bulwiengesa AG, rents in Germany rose by an average of 45 percent between 2009 and 2019, while purchase prices for apartments and houses soared by a whopping 72 percent. In the last year of this period, prices climbed by 6.8 percent compared to the previous year, more than twice as much as rents (+3.2 percent) - although price momentum has slowed somewhat compared to 2018 (+8.3 percent).

In view of the unbroken upward trend in real estate prices since the 2009 financial crisis, the question of the effects of the coronavirus pandemic is an all the more suspenseful one. Most forecasters had expected a more or less large price dip in the spring as a result of the pandemic for 2020 and/or 2021. At any rate, there are still no signs of a decline in real estate prices. In a flash estimate for the second quarter of 2020, the Federal Statistical Office ascertained a 5.6 percent increase in house prices compared to the same quarter of the previous year. The brokerage statistics for the real estate companies of LBS and Sparkassen also show that the average prices of properties sold in the first half of 2020 rose further compared with the previous year.

It should be noted, however, that the market has shrunk due to Corona and that this has contributed to the stabilisation or further upward drift in prices: According to empirica, in April, the phase when the lockdown was sharpest, significantly fewer new properties were advertised each week in the top 7 cities than on average since the beginning of 2019. LBS real estate brokers also had noticeably fewer properties on their books in April and May than in the same period of the previous year - among other reasons because the contact restrictions in force meant that hardly any viewing was possible for some time. The fact that rising prices were observed during this period of virtually frozen market activity may also have been due in part to shifts in the composition of the supply towards higher-quality properties for which there was still demand and willingness to pay. Finally, by June, business had almost returned to normal in volume terms.

Since it can now be assumed that construction activity will more or less maintain its pre-crisis level despite corona-related bottlenecks, the direction and dynamics of purchase price developments in the coming months and also in 2021 will depend more on demand-side than on supply-side determinants. Three positive factors feeding into the stabilisation story are that the number of unemployed in August rose only to the usual seasonal extent and no longer as a result of corona, that the ifo business climate index is recovering and that short-time working dropped off marginally in June. The fact that interest rates look set to remain extremely low in the foreseeable future contributes to the ongoing attractiveness of investing in real estate. However, there are major question marks hanging over the global cyclical trend and the local automotive industry, which was already struggling with difficulties before Corona.

In addition, it is unclear how migration trends are going to play out. It is very likely that labour migration from other European countries to Germany will increase again. But future domestic migration will also play a major role in moulding regional price trends. This, in turn, depends on which regions will come through the crisis better and which worse. Another point to bear in mind is that the living preferences of German citizens could also shift as a result of the Covid-19 experience and demand for housing in the outlying ex-urbs of the major conurbations and in attractive small and medium-sized cities with favourable transport links could rise.

5. The debate about real estate bubbles in Germany

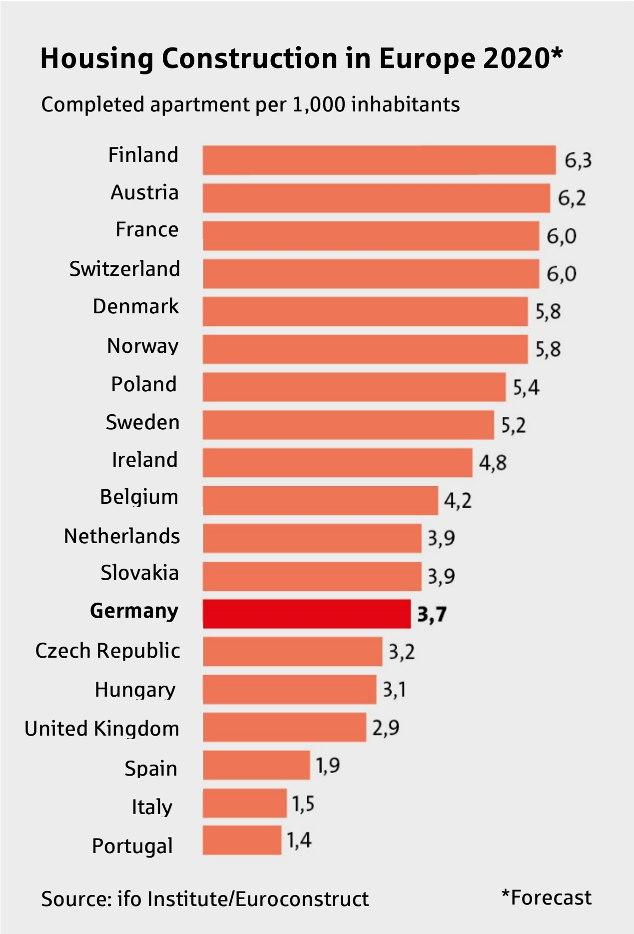
Whether a real estate bubble has been developing in Germany, the bursting of which could lead to serious distortions in the financial sector and the real economy, can be assessed at various levels on the basis of various indicators. Strictly speaking, the question consists of three components:

1. Is there a bubble? One speaks of a price bubble, i.e. speculative price overshoots, when price increases are primarily fed by the fact that the mere prospect of an increase in value generates a willingness to pay on the part of the buyers that is divorced from fundamental factors. The Bundesbank, for example, has been arguing for years that German residential real estate is overvalued by 15 to 30 percent - and Buba is not alone in this. For its bubble index, the empirica institute factors in relevant indicators such as the ratio of purchase prices to annual rents (multiplier) and annual incomes separately for all 401 districts and cities. According to this, in the second quarter of 2020, 68 percent of the districts were overvalued by comparison to the trend in rents, and as many as 81 percent by comparison with the trend in incomes. Empirica puts the potential for price setbacks in the top 7 cities at 42 percent; the national average being 23 percent.

2. Could the bubble burst - and if so, when? In theory, prices fall when demand collapses and/or supply increases excessively. The fact that the Corona crisis has not yet led to a noticeable drop in demand and prices is seen by various experts as proof that there is no real estate bubble. However, this cannot yet be said with certainty. It is also possible that the economic consequences of the Covid-19 crisis will not affect the propensity to purchase in the real estate domain until later.

What can definitely be asserted is that expanding building activity does not at present entail the risk of a nationwide bubble. Empirica recently diagnosed such a phenomenon in only 9 percent of districts. It is true that more housing units are now being built in the cities than just a few years ago. Nevertheless, an oversupply scenario is still a long way off - compared with the situation in Spain shortly before the financial crisis in 2008, when, for some time, more than 15 new housing units per 1,000 inhabitants were put on the market each year. At the moment, it looks as if slowly decreasing demand from both tenants and buyers – forced to resort to ex-urbs or more favourably-priced cities - is meeting with a slowly increasing supply of living space in the most expensive German cities. Together, these two factors suggest that the price trend could likewise lose momentum slowly, but that there will be no sudden downward corrections.

3. Would the bursting of a real estate bubble endanger financial stability? After the experience of the global financial crisis in 2009, this is certainly the most sensitive and complex aspect of the bubble question. The Bundesbank and the Financial Stability Committee see risks for financial stability if excessive lending and eroding lending standards come into play on top of sharply rising residential property prices. In order to be able to assess whether this is the case or not, the Bundesbank observes a whole range of key variables:



Measured in terms of gross domestic product (GDP), **the volume of housing loans granted by banks** to private households is now higher than it has been for ten years: the ratio was 38.3 percent in the first quarter of this year. It was last higher at the end of 2009 at 38.6 percent. However, in the years 2003 to 2006 it had already been over 40 percent. With regard to the so-called credit-to-GDP gap for housing loans (ie., the differential between the current ratio and the long-term trend), the Bundesbank wrote in its 2019 Financial Stability Report that it was not alarmingly high, but that it had been rising for some time. So Germany is still a good long way away from a situation of "excessive" lending.

The total debt of private households in relation to GDP rose by one percentage point in the course of 2019 to 54.6 in the fourth quarter. However, the debt-to-GDP ratio is still much lower than in the years prior to 2014 and is also still lower than in the euro zone (58 percent).

Lending standards were examined by the German banking supervisory authorities as part of the 2019 LSI stress test: around 1,400 banks classified as not systemically relevant were asked about real estate financing and lending standards in new business. According to the results published in September 2019, no significant relaxation of standards was observed. In the private housing finance segment, a moderate increase in the loan-to-value (LTV, the ratio of loan volume to the market value of the property) was observed, from 82 percent in 2016 to 84 percent in 2018. Redemption rates remained comparatively high at 3.2 percent in 2018. Overall, the Bundesbank assessed the lending standards on this basis as less conservative, but not as critical.

Long-term fixed interest rates also shield banks from payment difficulties on the part of their customers: There are hardly any housing loans with variable interest rates in Germany - their share was recently just over 10 percent. Half of the aggregate German credit volume has a fixed interest period of over ten years, another good 30 percent of five to ten years. This applies to a comparable extent in Europe only to France. In other countries such as Portugal, Latvia and Ireland, 80 percent of real estate loans carry variable interest rates. Rising interest rates are a direct burden on borrowers there and put their solvency to the test. Germany should be largely immune to this problem.

It is also worth mentioning a substantial difference between real estate lending in Germany and the situation in the USA: In the Federal Republic, borrowers are personally liable for the repayment of their loan. In contrast, in those US federal states where the subprime crisis ran havoc, it was possible to extricate onself from debt by handing over one's property to the bank in the case of imminent insolvency. However, the value of such housing had mostly fallen sharply. In addition, it is not possible, unlike in the USA, to extract equity from real estate in order to finance consumption on the basis of increases in value. The residential real estate credit directive prescribes strict lending standards for private consumers: the appraisal of their credit standing is based on strict guidelines for creditworthiness analysis, and the value of the property may only be taken into account to a very limited extent. The determination of the mortgage lending value of real estate is also based on conservative guidelines. All this reduces the probability of default on loans and limits the bank's losses in the event of default.

In recent years, the most frequent point of criticism from the supervisory authorities with regard to German real estate financing has always been the insufficiently granular and standardised data collection on lending, especially with regard to income-related parameters. For this reason, the Financial Stability Committee recently expressly welcomed the fact that these data gaps are to be closed with the help of the planned Financial Stability Data Collection Regulation (FinStabDEV). However, it is still uncertain when the regulation will enter into force (scheduled for 2020), when it is to be implemented and to what extent the banking industry's requests for changes with regard to a more appropriate data pool and the frequency and complexity of data collection will be taken into account.

The bottom line is that the benchmark metrics observed by the Bundesbank give no indication that even a substantial decline in residential property prices would put the banking industry under pressure.

6. Financial supervisory measures

Fortunately, the European and German banking regulators reacted quickly when governments took the first infection control measures and realised what serious economic consequences these would have. Capital requirements for banks were temporarily eased, the **countercyclical capital buffer** in Germany was reset to zero and the implementation of planned regulatory measures was postponed. The creation of so-called non-statutory moratoria has meant that deferred loans are not treated as defaulted for regulatory purposes. As a result, banks have been absolved from having to restrict their lending procyclically. According to the German Federal Financial Supervisory Authority (BaFin), the reduction of the countercyclical capital buffer is to be reviewed at the end of this year.

Even before the coronavirus struck, the activation of two other macroprudential instruments was also on the agenda - provided that the conditions for this were met: **"capping the LTV"** and an **"amortisation requirement"** (minimum amortisation). The aim of these measures would be to limit the risks of new residential real estate loans on the part of borrowers. The financial supervisory authorities would thus enforce minimum standards in lending over and above the already existing provisions of the Residential Real Estate Loan Directive and the Mortgage Lending Value Determination Ordinance. This would mean a far-reaching intervention in the housing finance market and a curtailment of the freedom of the contracting parties. Of all things, this could also affect home loan and savings financing, which, due to the typically high level of equity required and the higher repayment intensity, have an overall risk-reducing and thus stabilising effect on the system.

In view of the Corona crisis, which is far from over, the continuing great economic uncertainty and the solid situation in housing loans, it does not seem advisable to tighten the macroprudential reins again, let alone even more strongly. For the upshot of this would be to also make it more difficult to finance urgently needed new housing construction.

7. Housing policy

Despite all the discussions about real estate bubbles and banking-regulation countermeasures, it is also important not to lose sight of housing-policy necessities: It is and remains a political goal to create more - and thus, almost automatically, more affordable - housing. In addition, the strengthening of capital formation and private old-age provision continues to be on the agenda - and this implies that it must become easier again for German citizens to acquire residential property.

The recipes for this are well known, and to a large extent they were tackled by the political class during the current legislative period. It is a matter of building enough in the right places, strengthening the equity base of prospective homeowners, reducing ancillary acquisition costs and construction costs, and creating attractive regions to take pressure off the cities.

On the asset side of housing policy are, for example, Germany's “construction child benefit” - extending its duration would help to stabilise the economy -, the custom of splitting the broker's commission 50:50 between buyers and sellers, improvements in the housing construction premium, the draft of a law to mobilise building land (apart from the tightening of the ban on converting apartment buildings into condominiums, which the draft legislation also provides for) - and probably about 1.2 million new housing units. Although the federal government has thus missed the target of its housing offensive (1.5 million new units), it has nevertheless succeeded in bringing construction activity more closely into line with estimated demand.

Spotlight on Commercial Real Estate

People always need a roof over their heads, but what about commercial real estate? The fact that the coronavirus pandemic could lead to distortions here seems to be an accepted working hypothesis of most real estate analysts.

In its latest report to the Bundestag, the Committee on Financial Supervision dealt with the risks associated with commercial real estate financing in less detail than with residential real estate, but nevertheless expressed some concern: prices continued on their upward trajectory in 2019, albeit at a slower pace. The reduced price momentum was mainly attributable to retail real estate. At the same time, banks' commercial real estate loan portfolios grew strongly by 9.2 percent in 2019. In the Committee's view, the fact that commercial new financing in the portfolios of systemically important institutions is often structured with bullet repayment and variable interest agreements as well as restrictions on the liability of borrowers contributes to a build-up of cyclical risks. For the less systemically important institutions (LSI), the BaFin states, based on the survey results from 2019, that no clear deterioration in lending standards can be identified in the area of commercial real estate financing.

However, at least for the first half of 2020, the fears that have been voiced cannot be confirmed on the basis of the development of commercial property rents for the twelve most important locations analysed by the IW. Office rents have risen further in nine cities, while the decline in retail rents, which were already under pressure, has continued in some cases, although rents for retail space have actually risen in Düsseldorf, Frankfurt am Main, Hamburg and Dresden. Nevertheless, analysts continue to expect structural changes (e.g. in non-food retail) to be intensified by the corona pandemic.

Since real estate markets react sluggishly, statistically measurable market data on rent and purchase price developments will only become available after a sizeable time lag. Such data are closely correlated with the cyclical situation and the economic recovery in the various sectors. A wave of insolvencies still cannot be ruled out. In June 2020, 21 percent of the companies surveyed by the ifo Institute assessed the adverse effects of the corona crisis as threatening their very existence. In August 2020, however, the business climate index for Germany already improved noticeably again. Only the availability of data capturing developments up to the end of the first half of 2021 will make the extent of the impact in Germany tangible.

A look at the individual segments of the commercial property market:

Offices: "Price declines as a result of the coronavirus-induced recession are probable, but will not be serious initially," is a brief summary of various analyses. On the one hand, vacancies in the top locations are very low to date in this sphere, and on the other hand, despite the increased use of home office, office space is still needed to provide the necessary distances and communication facilities. The repercussions of an increasing number of insolvencies on the office market from 2021 onwards need to be observed.

Retail: The non-food retail sector was already experiencing major problems due to online trading before the coronavirus cast its shadow. The lockdown and, moreover, the general concern of people about infection dealt further blows to the bottom line of stationary retail sales. It is all the more surprising that the temporary reduction in value-added tax was apparently the right step to revitalise the city centres as well, and is not only benefiting virtual competitors. According to an IW survey, 4.2 million more passers-by were on Germany's main shopping streets in July than in June, 1.7 million of them because of the tax cut alone. In the ifo business climate index, however, this is only reflected in a decline in pessimism. Rising vacancy rates, falling rents and rental yields on retail real estate can therefore be expected.

Hotels: In the short term, all hotels suffered as a result of the Corona-related restrictions. In the meantime, it is becoming apparent that accommodation providers in German vacation regions may emerge from the crisis unscathed or even stronger. The situation is different in cities which lack international tourists, normal business travellers as well as trade fair and event visitors. A return to normality in all these areas will probably take even longer, with small business hotels and larger hotel chains suffering as a result. BayernLB therefore assumes that investor demand for hotel real estate is likely to decline.

Logistics: What is detrimental to retail real estate is beneficial to logistics real estate, also known as warehouses - the boom in online trade. Increased demand for storage space is bumping up against land-use planning constraints, which are likely to grow even more restrictive in future for reasons of nature conservation. BayernLB therefore expects rents and prices to rise.

Summary

The tectonic shifts in the commercial real estate sector will probably be more pronounced than in the residential market, but possibly less severe than initially expected. Statistically measurable results are not yet available. A potential impact on individual types of property use or locations will only become apparent in the coming ten months. Regional and sector-related differentiation is appropriate. In order to give credit institutions room for manoeuvre in this unfathomable situation, crisis-related macroprudential relief should be maintained for the time being.

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