German Mortgage Credit Standards Remain Procyclical

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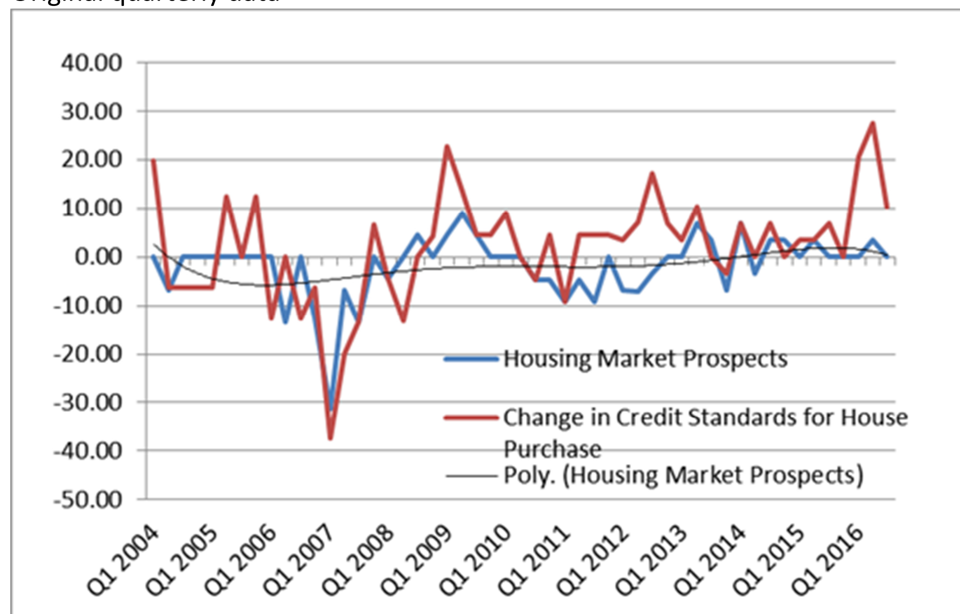
I analyzed the ECB Bank Lending Survey for Germany[2] today and in the below chart deck correlated housing market prospects and various credit standards. These are quarterly data from Q 1 2004 until Q 3 2016. Values above zero indicate relaxation, values below zero tightening.

Now, these are quotes by bank managers, which may or may not correspond to the reality of actual underwriting. However, in other European countries that I analyzed – see my CEPS paper of 2011[3] – they appeared to indicate financial vulnerability quite accurately. With the gratious help offered by Hypoport AG management I will try to substantiate these data with Europace transactions data, the mortgage broker platform owned by Hypoport that intermediates > 20% of the German market

So let us see what we got here: housing market prospects and general credit standards for housing appear to be closely correlated.

Original quarterly data



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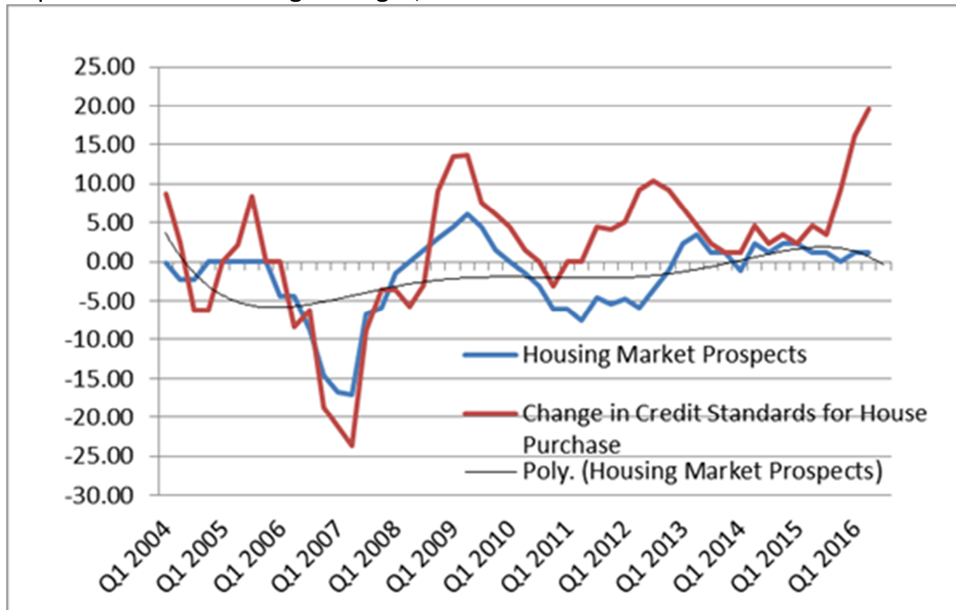
[2] https://www.bundesbank.de/Redaktion/DE/Standardartikel/Aufgaben/Geldpolitik/volkswirtschaft_bank_lending_survey.html

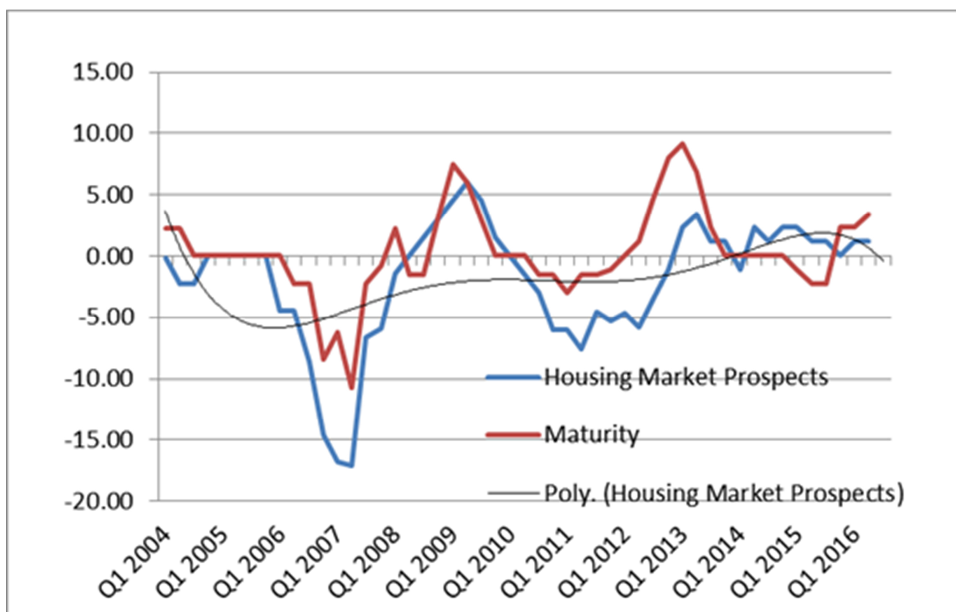
[3] http://www.finpolconsult.de/mediapool/16/169624/data/Housing_Finance/Europe/Duebel_CEPS_Mortgage_Paper_11.pdf, see figure 6

3 quarter central moving averages, which I use from here on



What jumps into the eye as violating the general procyclicity is a relaxation of standards in Q 1 and Q 2 2016 – a consequence of anticipation effects of the implementation of the new EU Mortgage Credit Directive?

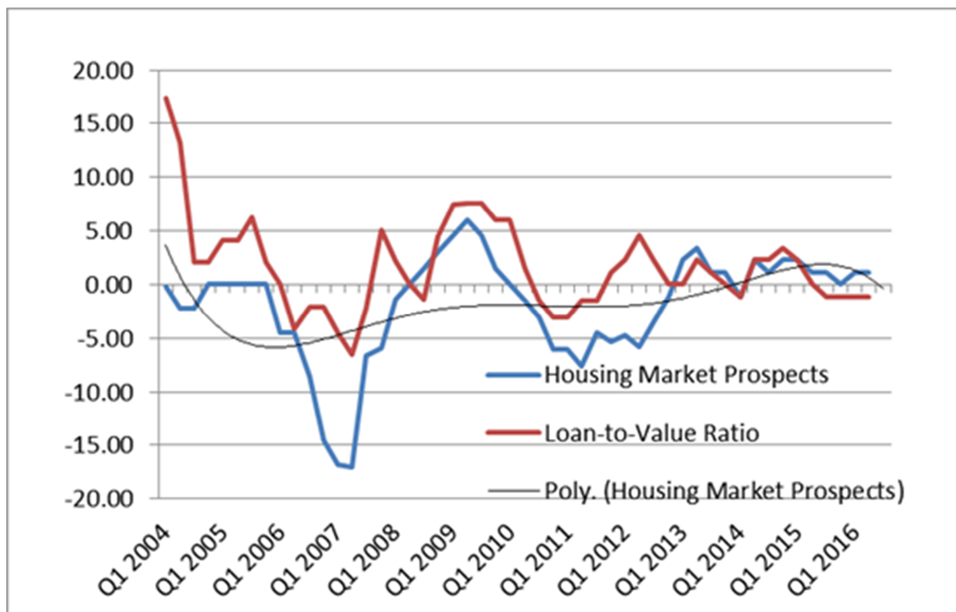
Going into more detail, maturities have been moving heavily procyclically as well. Note that German banks do not by default determine the maturity of a loan ex-ante, so this measure reflects likely the result of lower interest rates which combined with typical, more sluggish, initial amortizations policies chosen by borrowers in the range of 1, 2 or 3% then lead automatically, with declining rates, to higher maturities. So banks quasi on autopilot are running into extreme maturities and durations, adversely selecting borrowers as they move along.



The lack of control of maturity is an epic failure of our officials and politicians who read every wish of the savings and coop banks from their blue eyes. Reminds you of the US S&Ls in 80s? You are right on spot.

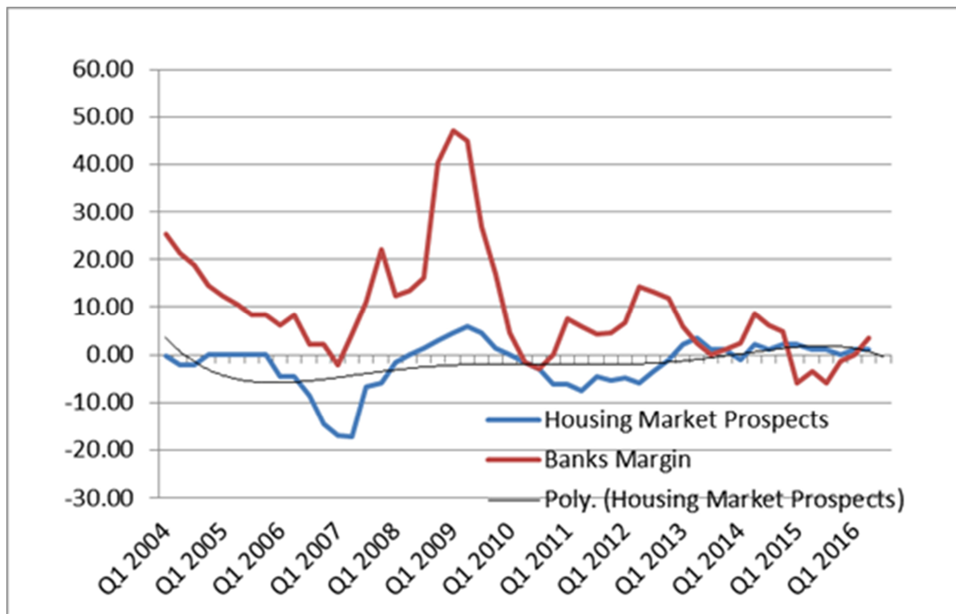
Maturities have moreover, as the chart shows, recently been increasing strongly again, I gave this week an interview in Die Welt where the reporter, who more closely than I covers the German market (I do mostly international work) reported of developers arranging financing at low initial amortization rates, i.e. high maturities. Is such more proactive standards relaxation a sign for the peak of the price development? See again my CEPS study for other European cases.

LTV ratios seem to not have followed maturities recently, although the long-term trend is clearly highly procyclical and pressure to increase LTV may pick up shortly again. Who was it again who proposed 'leaning against the bubble'? My personal view – substantiated by this data - is that we would gain already a lot if we kept LTVs stable rather than relaxing them with increasing price levels and vice versa (see the Draghi definition of a bubble, rising asset prices combined with rising leverage).



Finally bank margins over the ‚relevant market reference rate'. What that rate is exactly is quite unclear in the German case, but any indication given by banks is likely to reflect deposit rates. Margins have already collapsed some time ago to very low levels. They do of course not reflect the massive maturity mismatch taken by German lenders.

Typical new loan rate fixing periods are now around 15 years, i.e. at 2% rates and 2% initial amortizations we are talking about 11 years duration, funded all by short-term deposits (and not the Pfandbrief, as many might think regarding its motherland).



Suppose from here that the entire portfolio has a 5-6 year duration. Simple financial maths suggest that a 1% increase in rates will eat up twice the amount of capital held under the standardized approach of Basel XYZ, which is 2.8%. No margin left to generate additional buffer, given that banks generally suffer from ZIRP and NIRP and competition in mortgages is cut throat anyway.

And that is all without considering the consequences of procyclical credit standards which are relaxing in many corners. While the average German borrower, according to Hypoport platform data (intermediary for >20% of German mortgages), seems to have chosen somewhat higher initial amortization (nevertheless at rock bottom rate levels leading to higher maturity…) and kept LTV conservative, the pockets of vulnerability seem to be extending.

So the initiative announced by the Federal government to obtain the right to reign in LTVs or maturities is well taken.[4] Alas, that kind of authority might be needed at rather short notice, and many potentially costly mistakes are likely to have been made already.

[4] http://deutsche-wirtschafts-nachrichten.de/2016/10/24/bundesregierung-will-immobilien-kredite-regulieren/

PS – here the same chart not with 'housing market prospects' but with Hypoport's house price index EPX, which I helped to develop, one quarter ahead. 2009 was a special year in many ways, where all standard correlations broke down, but otherwise the expected relationship between standards today and prices tomorrow seems to broadly hold.