Sovereign risks from euro area periphery housing are contained as recoveries take hold

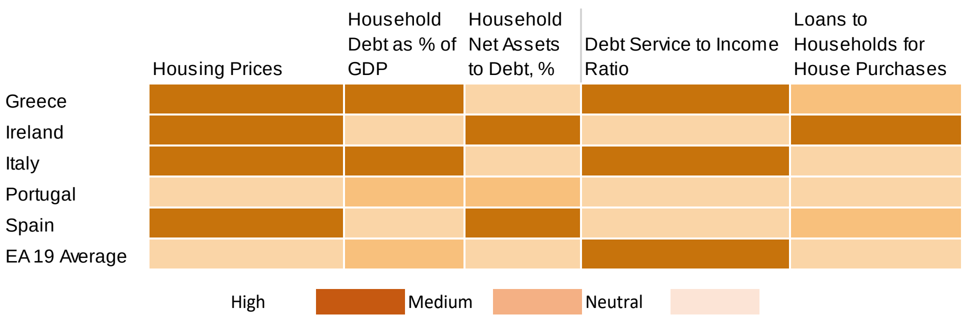
Scope Ratings

Ten years after the outbreak of the Great Financial Crisis (GFC), Scope believes that peripheral European economies (Greece (B+/Positive), Ireland (A+/Stable), Italy (A-/Negative), Portugal (BBB/Stable), and Spain (A-/Stable)) have gone through a significant housing market correction to reduce earlier excesses, especially in Greece, Spain and Ireland. As the regional recovery continues, the real estate market in most of these countries is expected to consolidate in 2018, especially in Ireland and Spain, where economic performance has been strong.

Scope does not expect full recovery in the housing markets until high levels of unemployment are brought down significantly. Hence, housing demand will remain soft in most countries, reflecting fundamentals also attributed in part to a continued property overhang from the excesses leading up to the GFC. Post-GFC housing price undervaluation in Ireland and Spain was reversed thanks to a price increase, according to OECD data, of 59.4% and 17.0%, respectively, with the price-to-income ratio returning to its historical average, supported by above-potential economic growth.

In Portugal, while housing prices have increased, recovery here lags due to still high household debt (at 82.1% of GDP in 2017, according to the Bank of Portugal), low productivity growth, and challenging demographics limiting income growth and housing demand. The outlook for the Greek housing market is subdued, in line with a still fragile growth outlook. While prices appear to have bottomed, they are unlikely to see meaningful increases until the recovery solidifies.

Figure 1: Housing risk dynamics – scale of reductions over the last 10 years



Source: OECD, national central banks, BIS, Scope Ratings GmbH calculations

Scope believes that current housing fundamentals in the euro area periphery do not resemble the excessive fragilities before and in the aftermath of the GFC. Scope recognises improving stability as the peripheral housing market moves towards greater shares for longer-term fixed rate mortgages. New macro-prudential rules and stricter banking regulation will reduce the formation of new bubbles.

The prospect of higher long-term interest rates as the European Central Bank normalises policy could, however, pose a challenge to property markets. Even in a scenario of higher rates, direct housing-related risks to peripheral sovereign balance sheets are limited in the medium term given strengthened household balance sheets, higher bank capital adequacy and the European Union (EU)'s new bank bail-in rules. Scope believes that banks in peripheral Europe, despite ongoing issues with profitability (Greece, Italy) and weakened lending, are recovering from the GFC, mitigating sovereign contingent liabilities, except for lingering banking-related risks in Italy and Greece. Ultimately, structural economic reforms to raise peripheral economies' growth potential and bring down unemployment are crucial for further recovery in housing demand and the fundamental health of domestic banks which, together, support sovereign-debt outlooks for each country.

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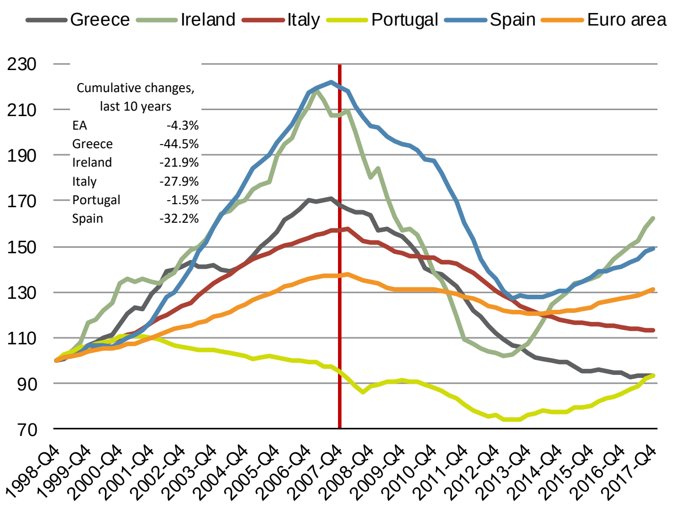
Housing market corrections with limitations to housing demand

Periphery housing market corrections despite low government yields

Normally, falling housing prices are triggered by higher interest rates as the costs of financing new homes increase, but this was not as much the case in the euro area periphery at the beginning of the GFC, when housing markets collapsed while interest rates remained relatively manageable. In real terms, cumulative changes in housing prices over the last ten years (**Figure 2**) have either fallen significantly or been stagnant: looking at cumulative changes since Q1 2008, real housing prices fell in Greece by 44.5%, Ireland by 21.9%, Italy by 27.9%, Portugal by 1.5%, and Spain by 32.2%. Post-GFC price rises in Ireland (+59.4%), Portugal (+26.8%) and Spain (+17.0%) have reversed only a degree of housing price undervaluation.

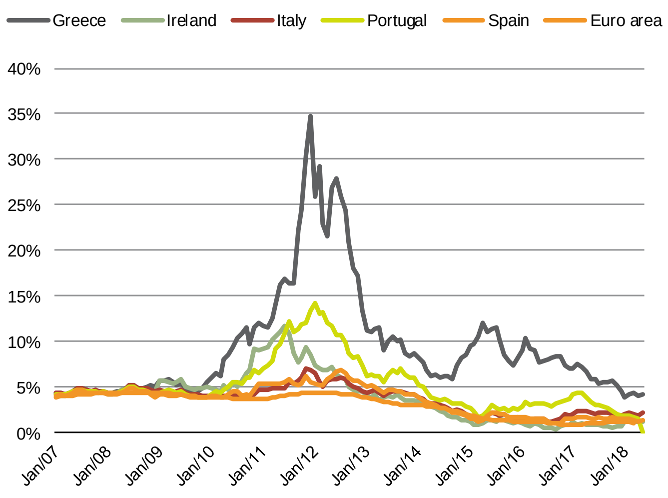
At the same time, real interest rates (**Figure 3**) in the periphery have fallen at least when compared with ten years ago, with real rates in Greece declining by 0.5%, Ireland by 3.6%, in Italy by 2.6%, in Portugal by 3.0%, and in Spain by 3.1%. These declines reflect the ECB's accommodative monetary policy and easy global central bank policies. Very low rates have supported the ongoing housing market recoveries.

Figure 2: Real house prices, 1998-2017, Q4 1998=100



Source: OECD, calculations Scope Ratings GmbH

Figure 3: Real ten-year government bond yields, %



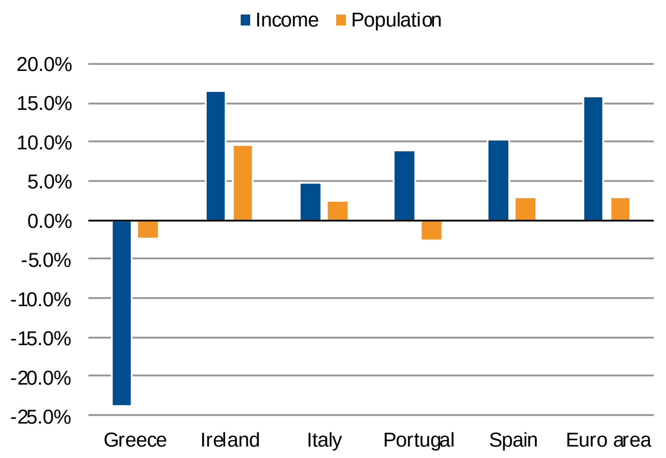
Source: National statistical offices, calculations Scope Ratings GmbH

Mixed picture on the housing demand side, owing to varying income growth stories

Growth in periphery housing demand **(Figure 4)** is mixed. While Greece is an outlier with both incomes and population declining by 23.8% and 2.4% since 2010, respectively, trimming housing demand, income levels elsewhere have improved, especially in Ireland, up by 16.6% since 2010.

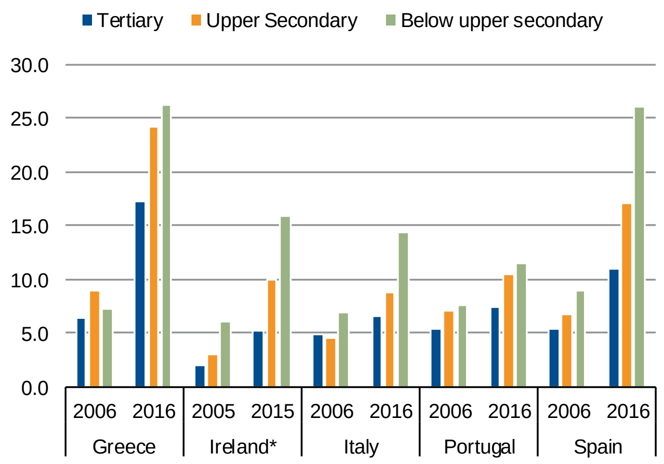
Income growth in Italy, Portugal and Spain are well under euro area averages, reflecting the long-term effects of the GFC on the economies. In Italy, tax incentives supporting hiring, as well as the lagged effects of labour market reforms since 2012, have raised employment, but weak economic growth has held income growth back. While Portugal has recovered around 450,000 of the 800,000 jobs lost during the GFC (reducing the unemployment rate to 7.4% in April 2018, its lowest level in over 10 years), discouraged workers and the underemployed still make up 10% of the available workforce, restricting stronger income generation. In Spain, elevated structural unemployment and low productivity growth combine to keep wage growth low. In stark contrast, the Irish economic recovery has been rapid, leading incomes to increase faster than the average cumulative of 15.9% since 2010 for the euro area.

Figure 4: Housing market demand, 2010-2017



Source: National statistical offices, Eurostat

Figure 5: Unemployment rate by educational attainment



For Ireland, the most recent data is from 2005 and 2015. Source: OECD, calculations by Scope Ratings GmbH.

Demographics and unemployment place further checks on housing demand

Demographics also place constraints on increases in housing demand, especially in Greece and Portugal, which saw population declines of 2.4% and 2.6%, respectively, over 2010-2017, in part driven by net emigration. Only Ireland has shown *significant* rises in population over this period (9.5%), which have helped drive Irish construction activity, albeit from levels still well below previous peaks. Population growth in Italy (2.5%) and Spain (2.9%) were closer to the euro area average over 2010-2017 of 2.9%.

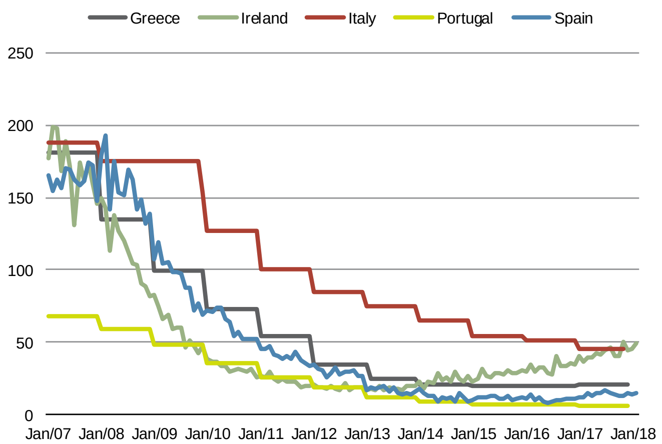
Critically, unemployment in the periphery **(Figure 5)** has increased significantly when compared with a decade before, with unemployment among the lower-educated in Greece up by 18.9 percentage points (from 7.3% in 2006 to 26.2% in 2016), in Ireland up by 9.9 pp, in Italy by 7.4 pp, in Portugal by 4.0 pp and in Spain by 17.1 pp. While unemployment has since declined since 2016, still high structural unemployment adds pressures on the robustness of recovery in housing demand. Scope notes that recent economic recoveries have been accompanied by overall increases in employment, with gains made among higher-skilled sectors.

Weak housing supply dynamics, except in Ireland

Weak housing completions and construction trends, except in Ireland

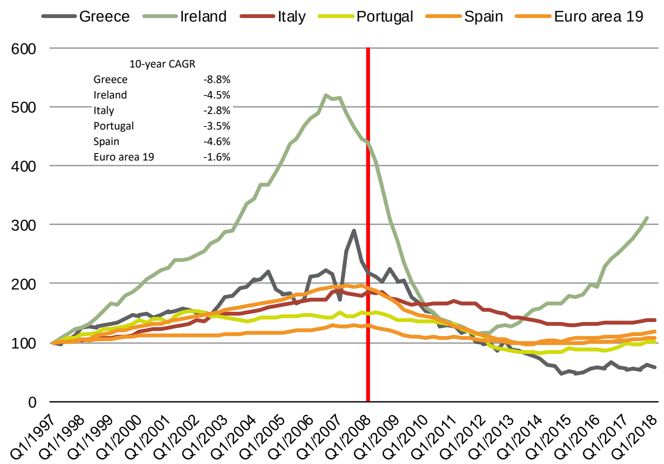
Due to weak demand drivers and the collapse of housing bubbles, housing market supply, measured by the number of dwellings completed **(Figure 6)**, in the periphery has largely failed to make significant ground over the last ten years. Scope estimates that housing completions in Greece have stabilised at very low levels. Ireland is the exception, showing an upswing, supported by continuing shortages in housing supply alongside a robust recovery in demand. The initial decline in completions in Portugal was not as extreme, with virtually no recovery since and a stock of mortgage loans that continues to decline. The number of housing completions in Spain has increased with economic recovery.

Figure 6: Housing completions, 2007-2018, thousands of dwellings



Source: National statistical offices, OECD, Haver Analytics, calculations Scope Ratings GmbH

Figure 7: Construction investments, Q1 1997=100

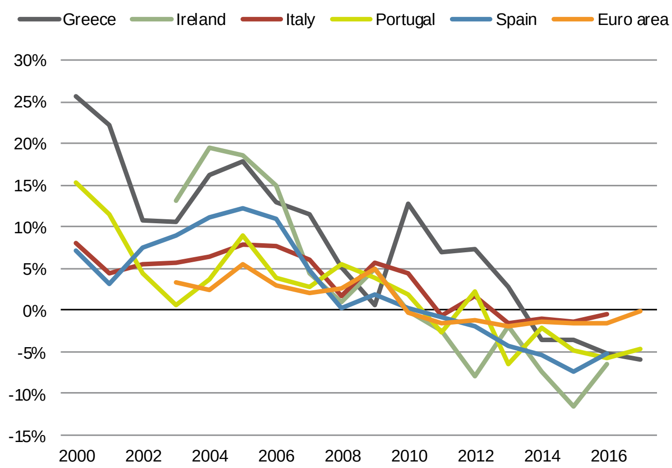


Source: IMF, Calculations Scope Ratings GmbH

The decline in housing completions is also reflected in overall construction investments, which have been lacklustre since the GFC. As can be seen in **Figure 7**, which covers a 20-year period[1], only Ireland has shown significant recovery and increases in construction investments after reaching troughs following the GFC. The strong construction upswing in Ireland is far ahead of that in other euro area periphery peers, up by 173.2% in Q4 2017 from the lows seen in Q4 2011.

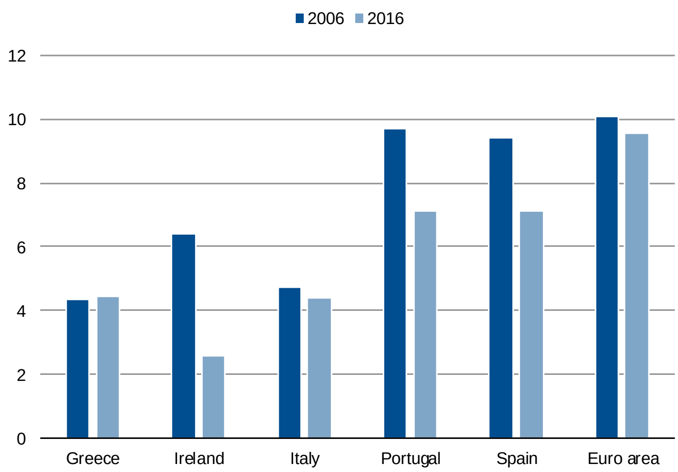
Household debt has increased versus wages

Figure 8: Wages to household debt, percentages



Source: National statistical offices, Haver Analytics, Scope Ratings GmbH calculations

Figure 9: Debt service ratios, % of household disposable income



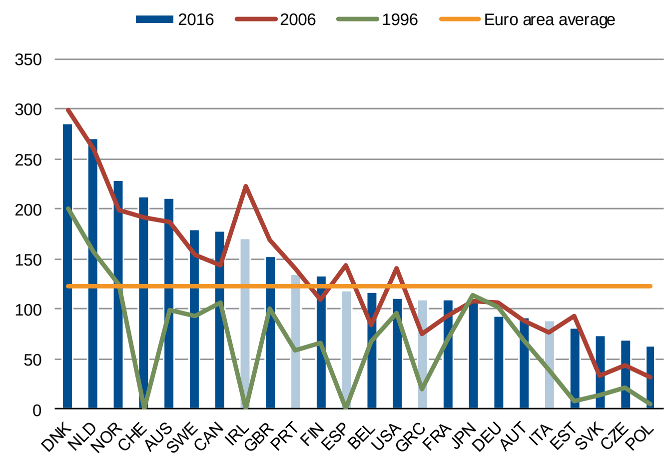
Source: BIS, Scope Ratings GmbH calculations

[1] The red vertical line in Figure 7 represents the midpoint.

Household debt growth has outpaced wage growth, but debt service ratios have fallen

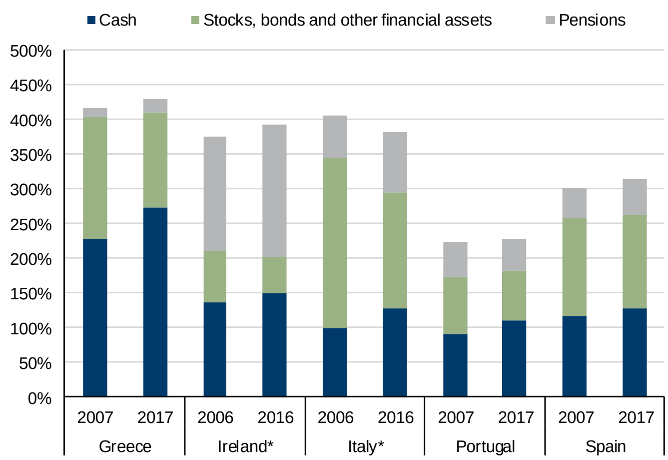
The ratio of wages to household debt **(Figure 8)**, measuring the pace of wage growth compared with the pace of debt accumulation, has fallen in the years following the GFC, most significantly in Greece and Ireland and the least in Italy and Portugal. Overall, wage growth has lagged growth in household debt, reflecting the increasing financial burdens of households. The fall, however, in debt service ratios (**Figure 9**) underscores how households have benefitted from the financial boon afforded to them by low interest rates. Scope notes that debt service ratios, even for Portugal and Spain, are low. **Figure 10** shows the periphery in the middle of the pack on household debt as a percentage of net disposable income, with Spain and Italy both under the euro area average and Ireland and Portugal above.

Figure 10: Household debt as a % of net disposable income



Source: OECD, Scope Ratings GmbH Calculations

Figure 11: Household gross assets as a % of net disposable income



*Ireland and Italy data reflect figures as of 2006 and 2016.
Source: BIS, Scope Ratings GmbH calculations

Household assets provide a buffer against debt risks

Ireland (**Figure 11**) benefits most from significant gross pension assets, significantly larger than that of other euro area periphery peers. Italian household assets are also elevated, reflecting significant stocks, bonds and other financial assets. Italian households have amongst the world's highest levels of available *net* wealth, with the latter standing at 194% of GDP in 2016. Portuguese households have, in comparison, the weakest position on gross assets, followed by Spanish households. Portuguese households have consistently increased their cash share in total net disposable assets over the last ten years, from 91.6% in 2007 to 109.8% in 2017, underscoring stronger savings during crisis periods. This is also true for Spanish households, which saw a significant correction in the value of their holdings of stocks, bonds, and other financial assets during the GFC, with cash increasing during this period. However, more recently, cash holdings have receded as stocks, bonds, and other financial assets have seen upward shifts. These significant household assets provide a buffer against housing- and household debt-related risks.

Outlook for housing markets

A strong acceleration in periphery housing activity is not anticipated

Scope believes that the economies of the euro area periphery continue to have imbalances generated by earlier excesses, although there have been significant market corrections at least in the area of housing, especially in Greece and Ireland. Scope does not anticipate a strong acceleration in housing activity going forward until high rates of unemployment are brought down significantly. Without higher employment and solid wage growth, domestically-driven housing demand will remain weak, further accentuated on the supply side by a continued property overhang from the excesses leading up to the GFC.

A pick-up in foreign-driven demand

Foreign-driven housing demand presents a different picture. In Greece, demand from foreign investors has picked up, returning to pre-crisis levels in 2016, aided by demand for properties in Athens and other popular tourist destinations and the "golden visa program" providing a five-year residency permit within the Schengen Area for real estate investors. Foreign-driven demand is also strong in Ireland, with foreign private equity companies increasingly present in the Irish housing market, making it more difficult for domestic buyers to afford housing as demand outstrips supply, with some indications that foreign demand may start to push housing prices in key high-demand areas up excessively.

In Italy, the volume of foreign-owned investments has also increased significantly, but much is aimed at office investment, with foreign investors making up 70% of corporate real estate investments in Italy in 2017. Foreign-demand-driven housing investments are aided by streamlined visa procedures and major tax breaks for foreign investors setting up fiscal residency in Italy. In Portugal, foreign investors, after the tax reforms of 2009, entered the housing market and foreign-based demand continues to increase, mainly in the high-end Lisbon market, despite increasing prices. In Spain, foreign-demand-driven housing investments (42% of overall demand) has also been up, supported by a return of British buyers owing to Brexit.

Scope recognises that interest rates are low and that the stability of lending procedures in the housing market is improving, with a movement towards longer-term fixed rate mortgages. Scope believes that the current housing dynamics in the periphery do not resemble the excessive fragilities before and in the aftermath of the GFC. That said, the strong interest of foreign investors in peripheral housing markets does create potential pockets of exuberant price increases, with a distinction between key tourist and cultural areas and elsewhere.

Banking sector improvements help ease housing risks

Housing risks mitigated by improved bank balance sheets

In all countries of the euro area periphery, the effects of the GFC on the banking system exposed deep imbalances that had been hidden during the economic boom leading up to the crisis. EU actions to address these problems led to a series of reforms, such as the creation of a banking union in 2012, as well as the design of new institutions (Single Resolution Mechanism in 2016 for example) that have increased the euro area's resilience. Risks of banking spill-over onto sovereign balance sheets owing to housing-related risks are now mitigated by the higher resilience of respective banking systems. Here, however, Italy is an exception due to its past bypassing of European bail-in rules. The existing sovereign-bank nexus in Italy is shown in government funds used in the rescues of Monte dei Paschi di Siena and two Venetian banks in 2017.

Greek banks have recently gone through a European Banking Authority stress test that showed positive results, which confirmed increased banking sector resilience and higher capital ratios needed to handle high non-performing exposures (NPEs). Under the adverse scenario of the stress test, none of the Greek banks needed additional capital. Scope believes that a full recovery of the Greek banking system will be gradual, however, and continue to rely on a supportive economic and political environment.

Coming out of the GFC, Irish banks have deleveraged, and capital adequacy positions have strengthened. Ongoing restructurings, asset sales and rising collateral values have improved balance sheets and asset quality. Non-performing loan (NPL) exposures remain relatively high but have fallen meaningfully.

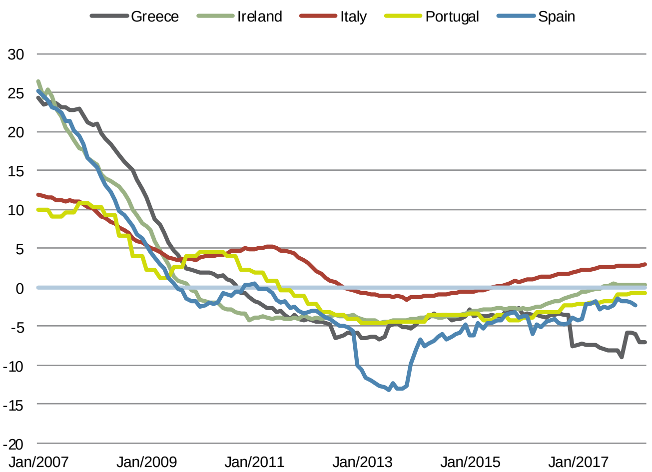
Italian NPLs are largely a legacy issue

Following a few difficult years, the Italian banking system is today in a much-improved position. Despite the lack of a systemic solution to the problem of legacy NPLs from the GFC, Italian banks have been successfully raising equity and using the proceeds of capital increases to reduce their levels of problem loans. Material progress has been achieved in reforming banks' governance, paving the way for consolidation, particularly in the Popolari sector. Scope does not believe that a deeper banking crisis will emerge, as bad debts and other non-performing loan exposures are largely a legacy issue and are being dealt with.

The resilience of Portuguese banks has increased due to stronger economic performance and the recent capital increases of four of the six largest Portuguese banks, aided by the restructuring of business models. Bank capitalisation is aided by recapitalisations and falling risk-weighted assets, with a common equity tier 1 ratio of 14.5% (as of 2017). Profitability was positive in 2017, recovering from a negative bottom-line in 2016, reflecting reductions in new impairments and an increase in operating incomes, resulting in a return-on-equity of 3.5%. Scope views positively a three-pillared strategy of legal and judicial reforms, prudential supervision and NPL management.

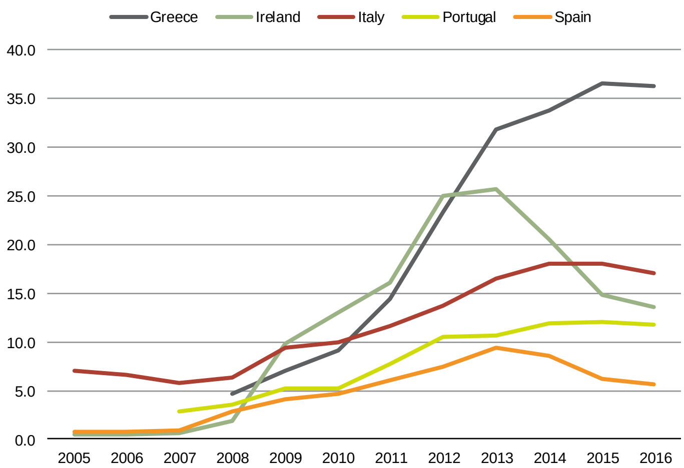
Spanish banks have also increased resilience, with improving asset quality and significant reductions in non-performing assets. Profitability, however, remains a challenge, reflecting net interest margins under pressure due to low interest rates, declines in business volumes and weakened balance sheets due to the high stock of non-performing loans. Banks, however, continue to benefit from ample liquidity and inexpensive funding from the ECB, with Spanish banks facing the same challenges as other EU-based banks as the ECB draws net asset purchases to a close.

Figure 12: Bank loans to households, Y/Y growth rates



Source: National statistical offices, Haver Analytics, calculations Scope Ratings

Figure 13: Non-performing loans, % of gross total loans



Source: World Bank, Haver Analytics

A fundamental challenge to the banking sectors is the still weak lending activity in the aftermath of the GFC (**Figure 12**). Here, Greece, Spain, and Portugal remain in credit contraction. Outstanding loans to the private sector, according to the central banks of the respective countries, are still down 26.1% in Greece compared with ten years ago, and similarly down in Ireland by 13.8%, in Italy by 6.1%, in Portugal by 11.0% and in Spain by 17.6%. The softness in lending activity in part informs the weakness of the housing recovery in the euro area periphery.

Improvements in NPL ratios set to continue

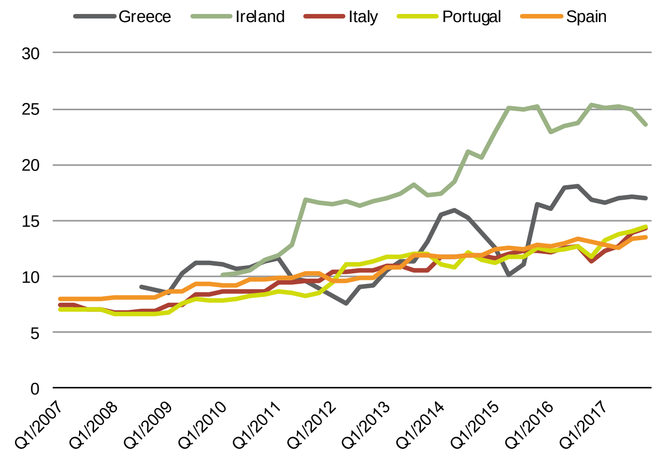
The legacy of the crisis (Figure 13) still affects the banking systems via the high level of non-performing loan exposure (NPE). Scope does not expect a major reduction in the

NPE of Greek banks in the medium-term as write-offs and sales will take time to execute. Italian NPE is being addressed with privately funded and government-supported solutions (the Atlante II fund, supported by the Italian Treasury guarantee scheme on NPL securitisation (GACS)). In Portugal, the three-pillared strategy to deal with NPLs is yielding results as expected, with NPR gradually declining t 13.3% of total loans in Q4 2017 from the 17.9% peak in Q1 2016 – a EUR 13.5bn reduction in the NPL stock. The NPL coverage ratio was also elevated at 49.3% as of Q4 2017. In Spain, NPE decreased from 5.6% in December 2016 to 4.4% in December 2017, aided by stronger economic growth and active management by banks.

Banking system resilience is increasing

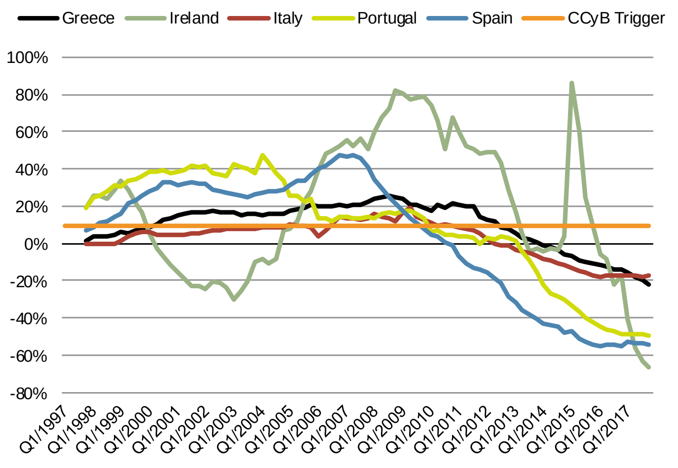
Programmes aimed at increasing the resilience of periphery banking sectors has seen recapitalisations. Regulatory tier 1 capital reserves to risk-weighted assets (**Figure 14**) increased in Greece from 7.5% in Q2 2012 to 17.0% in Q4 2017. The increase in Ireland's tier 1 ratio has been from 10.2% in Q1 2010 to 23.5% in Q4 2017. The increase in Italy is from 7.4% in Q2 2007 to 14.3% in Q4 2017. In Portugal, the increase has been from 7.0% in Q4 2007 to 14.5% in Q4 2017. In Spain, from 7.9% in Q4 2007 to 13.4% in Q4 2017. Scope views these enhancements positively, as the banking systems now meet or exceed tier 1 capital requirements for Group 1 banks (12.9% fully phased-in) and, except for in Spain, were above Group 2 requirements for smaller banks (13.8%). This adds a layer of resilience bolstering against housing-related sovereign risks.

Figure 14: Tier 1 capital ratios, % of risk-weighted assets



Source: IMF, Bank of Italy, Haver Analytics

Figure 15: Domestic credit to GDP gap[2], %



Source: ECB

Periphery banking sectors have recapitalised

Periphery banks continue deleveraging, with the credit-to-GDP gap (**Figure 15**) well under the counter-cyclical capital buffer (CCyB) trigger level of 9% of GDP. Greece shows moderate deleveraging, with the credit-to-GDP gap dropping to -21.9%. Deleveraging in Ireland has been extremely strong. In Italy, the credit-to-GDP gap is down more modestly at -17.4%. In Portugal and Spain, the credit-to-GDP gap has fallen to -49.7% and -54.3% respectively. These strong, sustained deleveraging cycles are positive in the sense that there is lessened risk of the euro-area peripheral economies overheating in a scenario of significant credit expansion.

Macro-prudential measures to address risks are in place

Macro-prudential measures have been introduced to address the risks and issues facing the banking sectors in the periphery. Scope views the introduction of counter-cyclical capital buffers positively: capital reserves are to be increased when cyclical risks are

[2] CCyB=counter-cyclical capital buffer. The spike starting in Q1 2015 in Ireland was driven by a one-off increase in credit to the private non-financial sector due to inversion effects captured under an updated System of National Accounts (SNA) methodology.

judged to be increasing, strengthening the resiliency of financial institutions during stress periods during which losses materialise. Scope notes that Spain has not yet established a national macro-prudential authority, with the Bank of Spain, Dirección General de Seguros y Fondos de Pensiones (DGFSP), and Comisión Nacional del Mercado de Valores (CNMV) independently conducting financial stability analysis on the banking and insurance sectors, and capital markets. These agencies also contribute to systemic risk surveillance at the European level under the leadership of the European Systemic Risk Board, along with the European Banking Authority, the European Insurance and Occupational Pensions Authority, and the European Securities and Markets Authority.

CCyB set to 0%

All euro-area peripheral central banks have CCyB set at 0% for Q2 2018. Greece announced that it will use this rate to support the extension of credit. Ireland maintains its 0% CCyB rate due to subdued aggregate credit growth, subject to revision if cyclical pressures grow and the credit environment continues to strengthen. The Italian CCyB rate reflects improving, but weak economic conditions with high, but falling, unemployment. The Portuguese rate reflects a positive business cycle accompanied with growing, but still negative, credit growth. In Spain, the rate reflects the large negative credit-to-GDP gap with little expectation of any turn-around in the coming quarters.

Limited Sovereign implications

Contingent liability risks for sovereigns are contained

Scope does not see indications of a developing housing price bubble in the peripheral countries, even with strong price recoveries in Ireland and, to a lesser extent, Portugal and Spain, as developments in these countries reflect a correction of severe earlier market downturns. Foreign investment in these countries does, however, to a certain degree increase the danger of exuberant price increases but is limited to a few major markets.

While Scope believes that the banks in peripheral countries have largely recovered from the GFC, profitability and non-performing loan issues, especially in Italy and Greece, coupled with overall weak lending activity, remain a concern going forward. Risks of higher long-term interest rates, for example as a result of ECB policy normalisation or rises in global interest rates, would increase bank interest margins, but also challenge housing markets.

Policy challenges remain, however, with high levels of unemployment and low wage growth limiting economic prospects. Hence the following policy areas need to be addressed: i) returning the long-term unemployed back to work; ii) support for policies that increase wage growth; and iii) revitalisation of construction investments.

As such, Scope believes contingent liability risks from housing for periphery sovereigns are largely *indirect* (for example, should housing risks result in a meaningful economic downturn, affecting growth, fiscal balances and debt sustainability). Scope believes that *direct* risks to the sovereigns from the banking systems (due to housing risks and mortgage exposures) are reduced compared to pre-GFC, reflecting strengthened balance sheets, higher bank capital adequacy and the EU's new bail-in rules.

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