Instruments to prevent risk of indebtedness becoming more common in Europe

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Macroprudential instruments and their combinations affecting the demand-side of credit, i.e. borrower-based measures, aim at containing household indebtedness and preventing the build-up of risks on the housing market. Even though the maximum loan-to-value (LTV) ratio (loan cap) is still the most widely used instrument in Europe, income-related macroprudential tools are also rapidly becoming more common. The ongoing review of the EU macroprudential regulatory framework provides an opportunity to improve and harmonise the use of borrower-based macroprudential instruments in Europe.

Macroprudential instruments affecting the demand-side of credit, i.e. borrower-based measures, refer to instruments designed to influence demand for loans and thereby household indebtedness. These restrictions most commonly pertain to housing loans, but other debt items are also increasingly taken into account when they are applied. The purpose of borrower-based measures is to contain household indebtedness and prevent the build-up of risks on the housing market. A maximum upper limit applicable to the loan-to-value (LTV) ratio for housing loans (loan cap) is still the most common macroprudential instrument in Europe, and it is also in use in Finland. In recent years, however, income-related borrower-based instruments have become more common in Europe.

Macroprudential policy in the EU is largely based on EU legislation that entered into force in 2014 and that has thereafter been specified, and on recommendations based on internationally agreed practices. Borrower-based macroprudential instruments fall within the scope of national legislation. This is why there are considerable cross-country differences in these tools in Europe. Their objectives, definitions, calibration, binding nature and legal basis vary. The European Systemic Risk Board (ESRB) has recommended many countries – including Finland – to expand the set of borrower-based instruments.[1]

The ongoing review of the EU macroprudential regulatory framework provides an opportunity to harmonise and improve the use of borrower-based measures in Europe (see Macroprudential toolkit should be replenished in Finland and Europe). Some of the major EU countries and the countries most affected by the financial crisis have adopted macroprudential tools more slowly than EU countries on average. To date, six EU and EEA countries – including Italy, Spain and Germany – have not used borrower-based instruments at all.

The risks associated with the housing market, and the real estate market in general, have long been pivotal to the macroprudential policies of the EU countries.[2] The financial stability vulnerabilities stemming from the housing market and housing finance have increased further in a number of EU countries. Many countries have taken steps to contain mortgage credit growth by, for example, limiting the size of loan granted to an individual borrower.

The most common borrower-based instrument targeted at mortgage credit is the maximum loan-to-value (LTV) ratio, i.e. the loan cap, which limits the amount of loan relative to the value of the purchased property or collateral. LTV limits are in use in 23 EU and EEA countries, including Finland (see Table). The level of the loan cap typically ranges between 80% and 95%. In many countries, regulation takes into account the intended purpose of the housing. In the case of first-home purchases, the size of the loan may often be larger relative to the value of the purchased property or collateral than in the case of other housing loans. This also pertains to Finland. In some countries, the loan cap is significantly lower for buy-to-let properties than for owner-occupied homes. Of the countries that have adopted borrower-based tools, only Finland, Denmark and Luxembourg have in place just one instrument, namely a maximum LTV ratio.[3]

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1. See Recommendation of the ESRB on medium-term vulnerabilities in the residential real estate sector in Finland.

2. See ESRB's report Vulnerabilities in the real estate sectors of the EEA countries.

3. In Denmark, the banking supervisor has issued other detailed instructions to banks on housing lending. In Finland, the Financial Supervisory Authority requires that the loan applicant's repayment capacity also be tested at a higher interest rate. Luxembourg, in turn, has also introduced a maximum debt service-to-income (DSTI) ratio,

Income-related macroprudential instruments are built on the borrower's repayment capacity. They limit, in relation to the borrower's income, the size of the loan granted (loan-to-income ratio, LTI), the borrower's total debts (debt-to-income ratio, DTI), the costs of servicing the loan (loan service-to-income ratio, LSTI) or the costs of servicing the borrower's total debts (debt service-to-income ratio, DSTI). Over recent years, limits on DTI or LTI and DSTI ratios have fairly rapidly become more common in Europe, and over half of EU and EEA countries currently have some kind of an income-related instrument in place. In 2018, only one-third of the countries had adopted a binding income-related instrument. Of income-related macroprudential tools, limits on the DSTI ratio are more common in Europe than limits on the DTI or LTI ratio, while some countries have both instruments in place.

Income-related instruments are often part of a macroprudential toolkit that also includes a maximum limit on loan maturity or an amortisation requirement. In such cases, regulation related to loan amortisation or maturity often supports the use of an income-related instrument and prevents the circumvention of regulation through extension of loan maturities. In the Baltic States, for example, the maximum loan maturity aims to support the effectiveness and efficiency of the maximum DSTI requirement. European countries have less experience of the use of the maximum loan maturity as an independent instrument, i.e. without being combined with an income-related instrument. This is planned in Finland.

but it has not been activated.

Table 1.

Macroprudential instruments affecting the demand-side of credit becoming more common in Europe

1. ● Legally binding instrument
2. ● Recommendation or non-legally binding instrument

Borrower-based macroprudential instruments in use in EU and EEA countries

Instrument	Maximum LTV ratio	Maximum DTI or LTI ratio	Maximum DSTI ratio	Amortisation requirement	Maximum loan maturity
Netherlands	1				2
Belgium	2	2	2		
Bulgaria					
Spain					
Ireland	1	1			
Iceland	1		1		
Italy					
Austria	2		2		2
Greece					
Croatia					
Cyprus	1		1		
Latvia	1	1	1		1
Liechtenstein	1			1	
Lithuania	1		1		1
Luxembourg	1				
Malta	1		1		1
Norway	1	1		1	
Poland	1		1		1
Portugal	1		1		1
France			1		1
Romania	1		1		1
Sweden	1			1	
Germany					
Slovakia	1	1	1	1	1
Slovenia	2		1		1
Finland	1				
Denmark	1				
Czech Republic	1	1	1	2	2
Hungary	1		1		
Estonia	1		1		1

Sources: A review of Macroprudential Policy in the EU in 2020, ESRB, July 2021; ESRB databases, and notifications by national macroprudential authorities.

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Tags

housing loans, indebtedness, macroprudential instruments, macroprudential policy