HNB

Croatia: Residential real estate market and financial stability during the pandemic

Joint Vienna Institute - The Impact of COVID-19 on Residential Real Estate

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The views expressed in this presentation are authors` alone and do not necessarily reflect the views of the Croatian national bank.

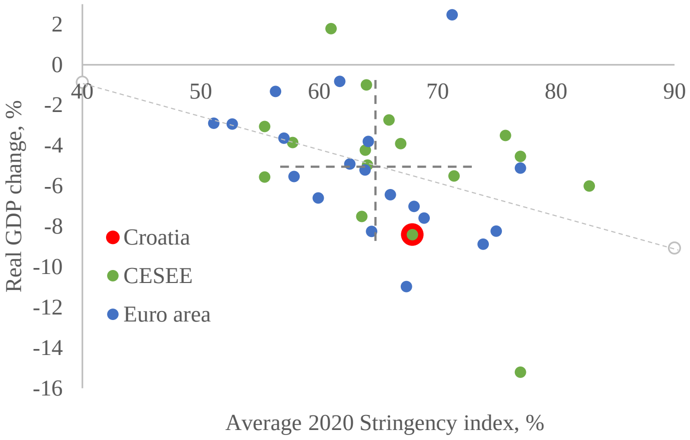
Agenda

1. Introduction
2. Recent real estate developements
3. Implications for financial stability
4. Conclusions

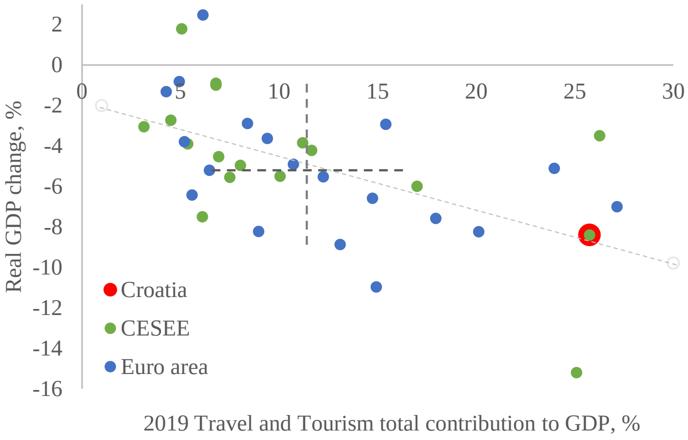
1. Introduction

Croatian economy slowed down considerably in 2020

Resulting from the anti-epidemic measures



… and the structure of the economy

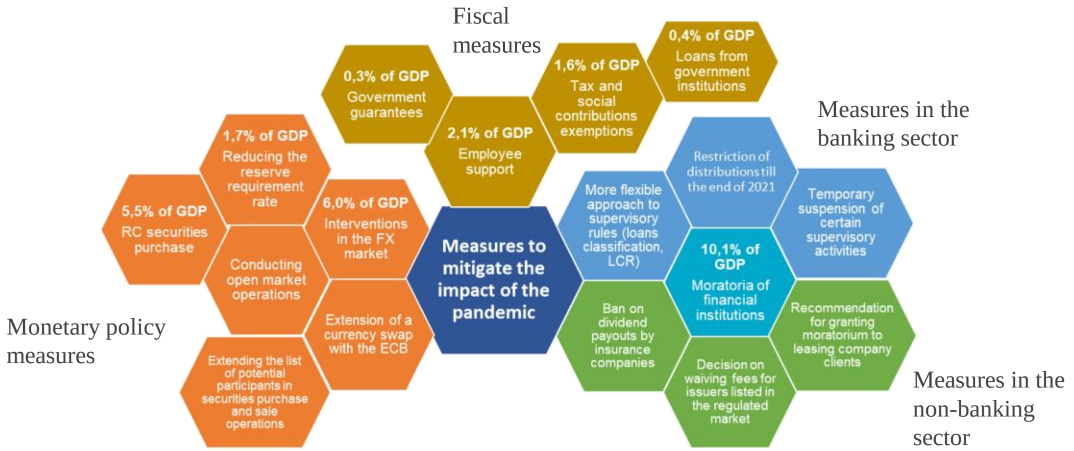


Note: Cross represents the average.
Source: GDP growth - IMF WEO (April 2021), HNB for Croatia, Travel and Tourism total contribution to GDP (2019) – World Bank (https://tcdata360.worldbank.org)
Stringency index – Blavatnik school of government and University of Oxford Covid-19 government response tracker.

- In 2020 Croatia recorded the strongest single-year GDP decrease in history: a) anti-pandemic measures slightly above average, b) the contribution of services (travel and tourism) to GDP is traditionally high.

An abundant relief package was implemented

Joint policy response in Croatia



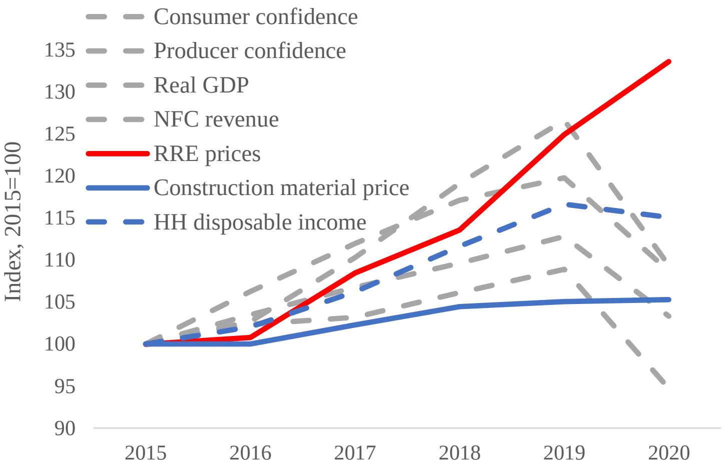
Notes: Data refers to period March 9 - December 31, 2020.
Source: HNB

- To cushion the negative effects of the pandemic (and anti-pandemic response), Croatia implemented an abundant, relief package. According to the ESRB, Croatia is in the top 5 EU countries regarding the package size (dominated by the moratoria).
- This allowed for some „breathing space": a) a significantly lower number of NFCs left the market, b) unemployment increased only marginally, and c) NPL ratio remained stable.

2. Recent real estate developements

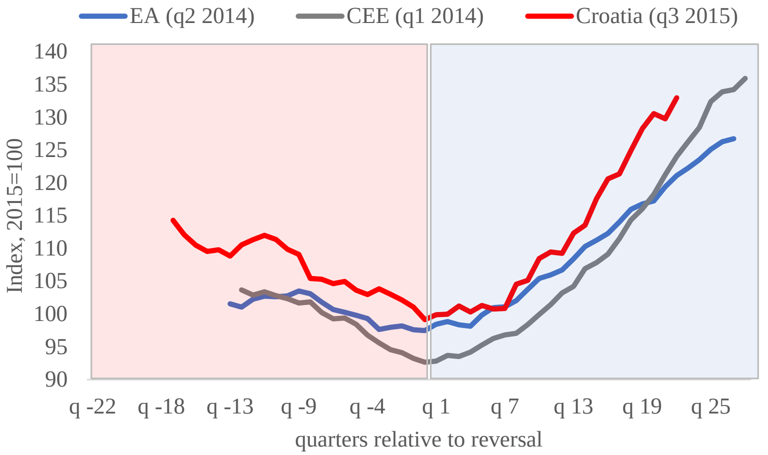
However, real estate prices continued to increase

Real estate prices defying gravity



Source: HNB, Croatian Bureau of Statistics

Strong growth in EU comparison after the reversal



Note: Weighted with GDP, PPP. Croatia not included in CEE.
Source: Eurostat (House price index), World bank (GDP)

- Unlike the macro-environment that deteriorated in 2020, RRE prices continued to increase. This divergence is notable even taking into account the potential lag between the fundamentals and RE prices.
- Croatia started recording a strong increase in RE prices a couple of years before the pandemic.

External drivers of real estate developments

Government subsidies

- Introduced in 2017,
- The government pays 1/3 to 1/2 of the monthly instalments,
- Applications concentrated in a single month,
- Stimulating the demand side,
- Around 30% of all 2020 RRE transactions follows from this subsidy.

COVID-19

- Digital transformation of many companies (working from home),
- Demand for larger apartments and apartments outside the city centre,
- Sudden-stop of tourism,
- Turning short-term rentals into longer-term (in Zagreb in particular).

Earthquakes

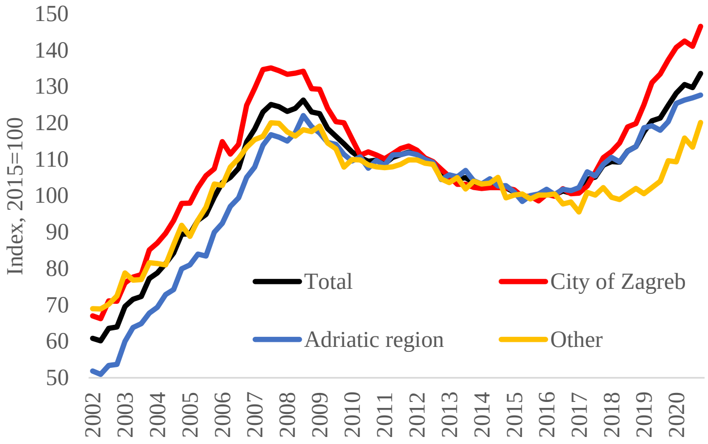
- 22 March 2020 – earthquake of magnitude 5.5 (on Richter scale) – 7 km from Zagreb city centre,
- 28/29 December 2020 – a series of earthquakes around Petrinja (50 km from Zagreb city centre) with the strongest of magnitude 6.2 (on Richter scale),
- Earthquakes reduced the supply and stimulated market fragmentation.

Other drivers

- Low-interest rates,
- Underdeveloped financial markets,
- Strong economic growth in recent years,
- Traditionally high owners occupancy,
- Tourism boom in Zagreb in recent years.

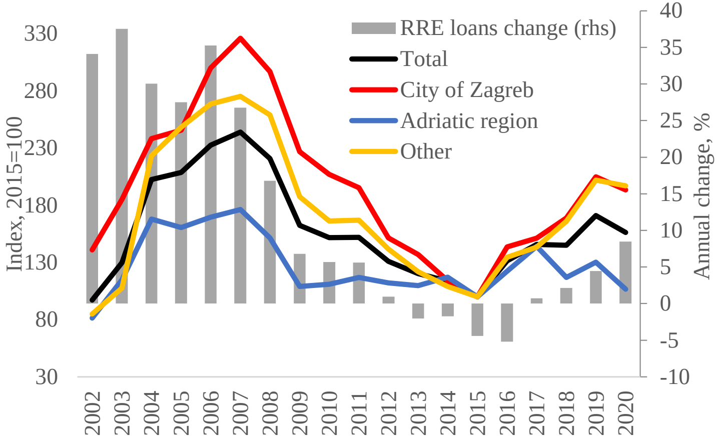
This time is different – structural change in acquisition method?

Prices exceeded their previous all-time-highs



Source: Croatian Bureau of Statistics, Tax Administration

However, purchases technique changed



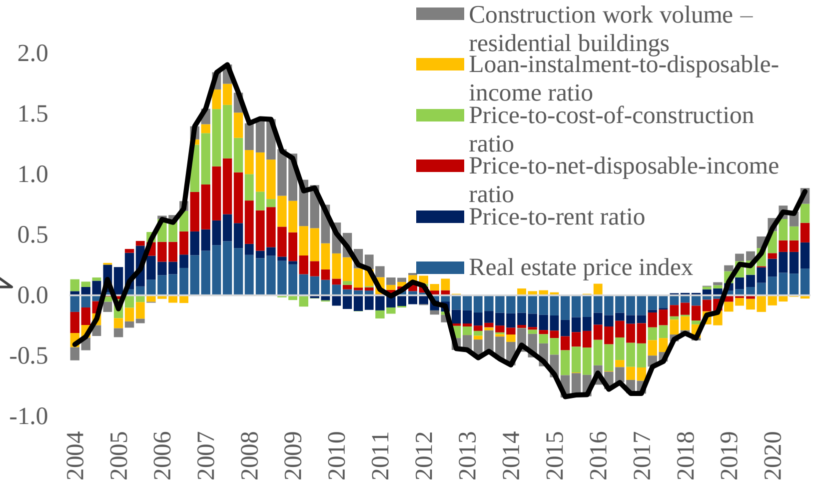
Source: HNB, Tax Administration

- Former record levels (2008) were surpassed at the end of 2019 with the City of Zagreb leading in growth.
- However, this time the prices grow on a smaller number of transactions and less fueled with RRE loans.

Creditless overvaluation?

- Loan fuelled (EUR, CHF loans),
- Increased bank competition,
- Strong economic growth,
- Construction boom,
- An increasing number of retail investors on capital market.

Overvaluation / Divergence indicator



Source: HNB calculation (Croatian Bureau of Statistics, Tax Administration data)

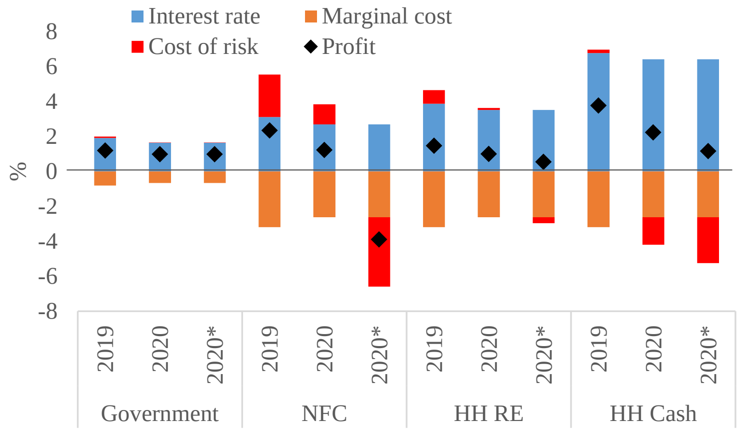
- Generally less fuelled by loans,
- Government subsidies,
- Low-interest rates,
- Lack of other investment opportunities,
- No construction boom – lower turnover.

- Macro environments has changed significantly compared with the previous boom.
- Investment focus is currently more concentrated on RRE.

3. Implications for financial stability

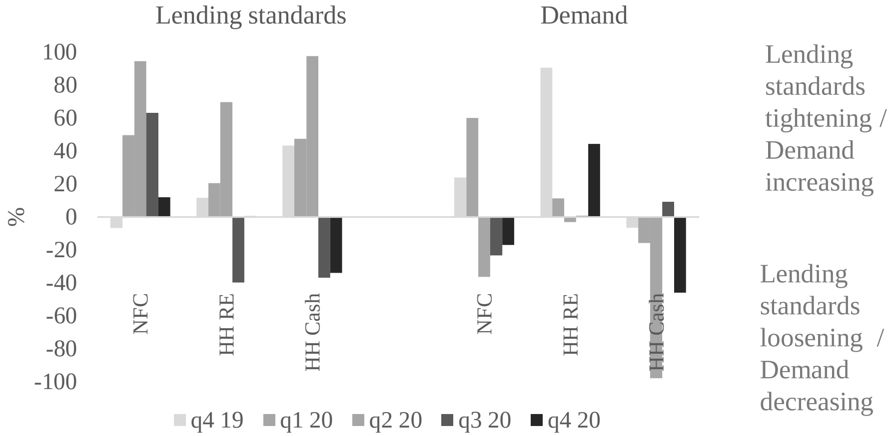
From the banks` perspective – not much choice?

HH RE loans became relatively more profitable in 2020



Note: Marginal cost is calculated according to: Van Leuvensteijn, Kok, Bikker and Van Rixtel (2008). * marks the modification for the year 2020 by replacing the actual credit losses with model assesment.
Source: HNB

... while lending standards generally tightened and demand decreased

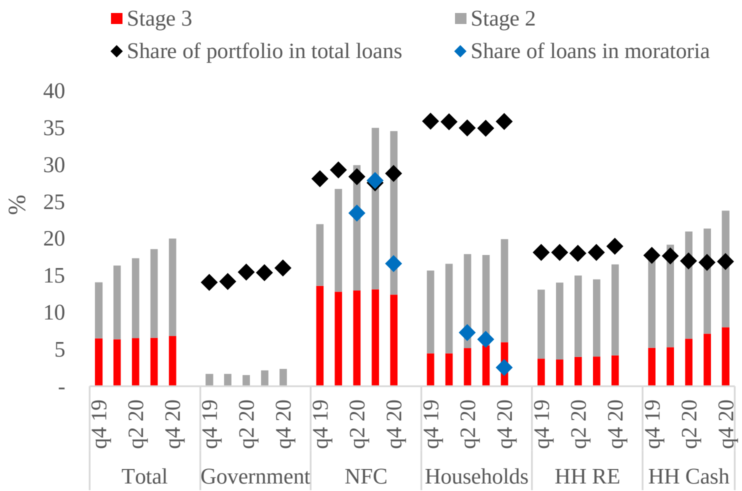


Source: HNB (Lending survey)

- Real estate loans to Households became relatively more attractive for banks: a) NFC portfolio is marked with uncertainty, b) HH Cash loans are less in demand, c) Yield on the government is low. Also, banks tightened the lending standards while the demand generally decreased.
- Capital adequacy and surplus liquidity on historical highs – the banking sector has large credit potential.

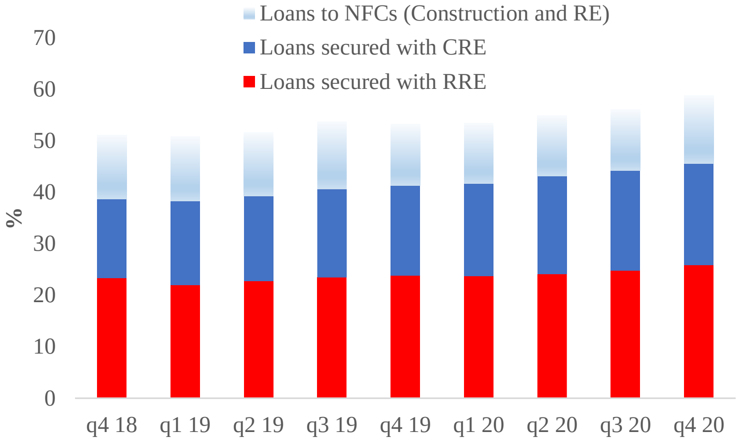
Bank asset structure is changing

Shift towards safety or towards what`s in demand?



Source: HNB

A significant portion of loans (to private sector) are (somehow) connected with the RE



Source: HNB

- Government and RRE portfolios currently gaining share - shifting towards safety will burden the profitability in the longer run.
- Exposure to RE is in reality higher than what the Balance sheet data would suggest: banks finance the supply side as well, a part of cash loans usually pour into the RE, clients work in the Construction industry, etc.

4. Conclusions

Real estate market - An undeserving champion?

- The real estate market in Croatia could be just the random winner benefiting from various „environmental” drivers (coronavirus, earthquakes, low-interest environment, lack of alternative investments, ...).
- Since current growth was not fuelled by excessive lending, macroprudential actions might be of a limited impact. HNB introduced two macroprudential measures that were not aimed at curbing the RRE prices growth, but are connected with the RE market:
  - 2017 - a strict DSTI of 25% for mortgages for sensitive clients (the result of implementing EBA Guidelines and new Foreclosure Act),
  - 2019 - a Recommendation to apply the same creditworthiness criteria to longer-term consumer loans, preventing the potential regulatory arbitrage arising from increasing volumes of consumer lending in 2019.
- The price increase was based on a lower number of transactions and to some extent bypassing the banking sector; does this leave the door open for the swift reversal?

The issue with single crisis attention

- After the GFC, the focus was primarily on preventing/limiting the negative effects of the financial leverage / financial crisis.
- In the years 2020 /2021, the focus is on the operating leverage (NFCs fixed costs) burden.
- It is necessary to monitor both as the economies are becoming more sensitive to further shocks:
    - NFC`s buffers are deteriorating,
    - Indebtedness is increasing,
    - Prices are increasing.

Thank you for your attention !!!

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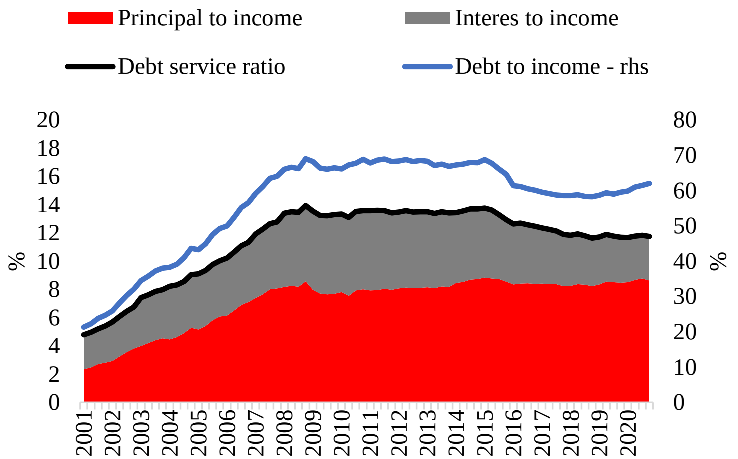
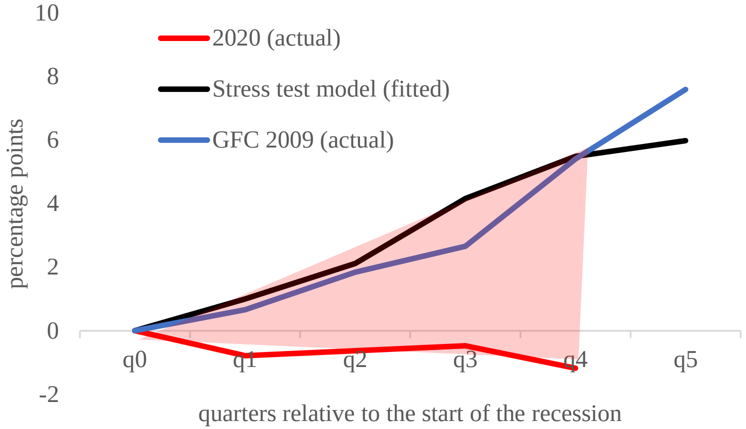
Looking a bit deeper at clients` performance

Households' credit-worthiness is sensitive to interest rates



Source: HNB

Uncertainity regarding the NFC portfolio is high



Source: HNB

- Household Debt servicing to a large extent results from decreasing interest rates. The income started to lose momentum in 2020.
- NFC NPL ratio currently much lower compared with a model forecast or GFC historic data.