Housing: current recovery & lending conditions

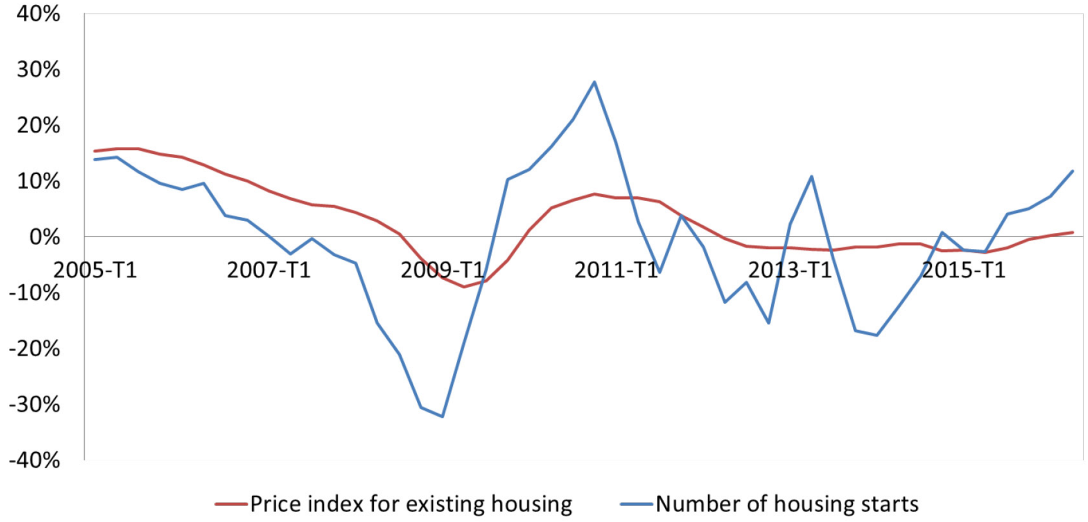
By Simon Ray

The French real estate market has improved, in particular as a result of the very favourable lending conditions: the latter have increased households' borrowing capacity. This capacity has grown by nearly 20% since 2014. This is chiefly thanks to lower interest rates followed by an increase in the duration of the loans, both related to an exceptionally accommodative monetary policy. A summary indicator helps measure this improved borrowing capacity.

The number of housing starts has increased significantly since the end of 2014 (+ 11%), mainly over the past year (see the blue curve in Chart 1). At the same time, prices on the existing housing market were up by almost 1% year-on-year after more than 10 consecutive quarters of moderate decline (red curve).

Chart 1: A recovery in housing starts

% year-on-year growth



Sources: Insee-Notaires; Ministry of the Environment, Energy and the Sea.

A strong link with the improvement in lending conditions

The dynamics of real estate activity (acquisitions of new and existing dwellings, plus major works) are closely linked to households' ability to finance their investments (Avouyi et al., 2014). Bank loans are an essential resource for financing a large majority of real estate projects. According to the Ministry of the Environment, the flow of new housing loans extended to households accounted for 47% of the financing of real estate activity in 2014. Its importance is particularly crucial for first-time buyers who do not have any capital to be reinvested. By increasing demand in a market where supply is constrained by the availability of land, favourable lending conditions therefore put upward pressure on real estate prices. The existence of a causal link between the supply of credit and the level of real estate prices has been highlighted in several recent studies (Favara and Imbs, 2015, Labonne and Welter-Nicol, 2016).

An indicator of households' borrowing capacity

The French system is characterised by the frequent use of guarantees by a credit institution (a third of outstandings in 2015) or by an insurance company (over a fifth), contrary to the Anglosphere where mortgages predominate. In France, the amount and decision to extend a loan are not so much based on the value of the property acquired and the outlook for local price developments, but on households' repayment capacity, which is measured by their income at the time the credit is granted. This primacy is a factor of financial stability but restricts access to credit to households whose future income is easily foreseeable.

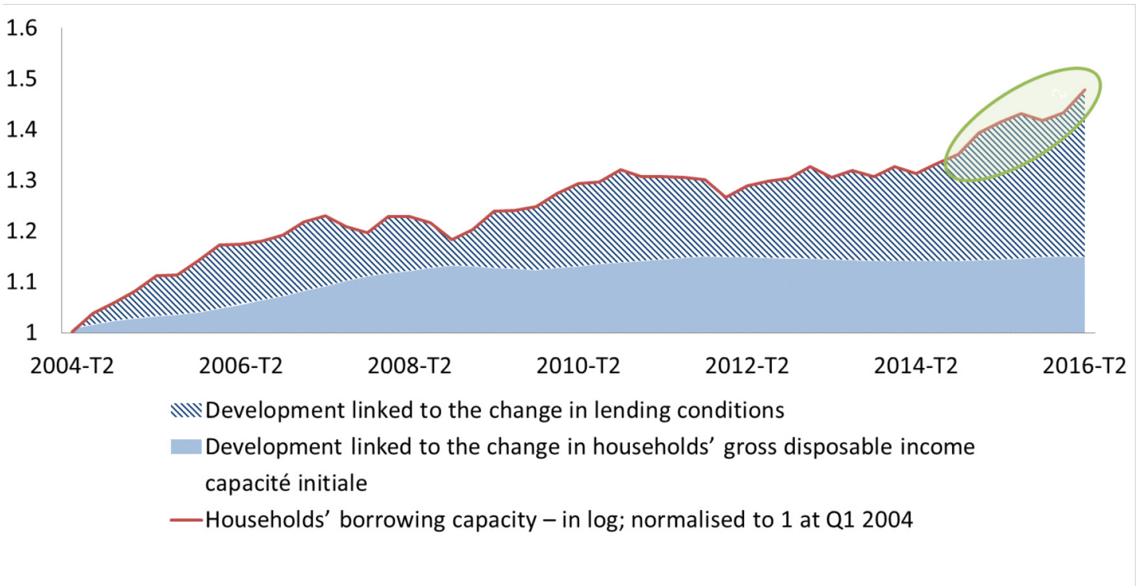
Households' borrowing capacity is the maximum amount a household can borrow to acquire a dwelling under the lending conditions prevailing in the market. Given the French system, the borrowing capacity is mainly the result of a combination of four factors: the level of income at the time the loan is granted, the maximum share of that income that can be used to repay the principal and interest, the interest rate and the initial maturity of the loan. We construct an aggregate indicator of households' borrowing capacity by considering the average borrowing conditions observed on the credit market. This indicator reflects the changes in the sum – discounted at the market rate – of the maximum monthly repayment capacities over the average maturity of a loan. This indicator differs from that of the purchasing capacity, which takes account of changes in the real estate price index.

It can reasonably be assumed that the maximum share of income that a household is able to devote to the repayment of the loan is a structural component which does not vary over time. While it can theoretically influence the risk premium and thus the observed average rates, it has not affected the results concerning the dynamics of the borrowing capacity over the period under review. French banks usually set it at one-third of the current income, subject to a sufficient "living allowance" (remaining income after payment of the amount due, fixed according to the size of the household). The variation in the borrowing capacity therefore depends on the combined dynamics of income and lending conditions.

A borrowing capacity up by nearly 20% since 2014

Chart 2 shows the changes in our indicator of households' borrowing capacity as well as the contribution of lending conditions (rate plus loan maturity) and gross disposable income per household to the changes in this indicator. Households' borrowing capacity has increased by close to 20% since the beginning of 2014 (and by almost 7% over 1 year), due to improved lending conditions (hatched area), while households' gross disposable income has hardly varied (blue area).

Chart 2: A sharp rise in the indicator of households' borrowing capacity



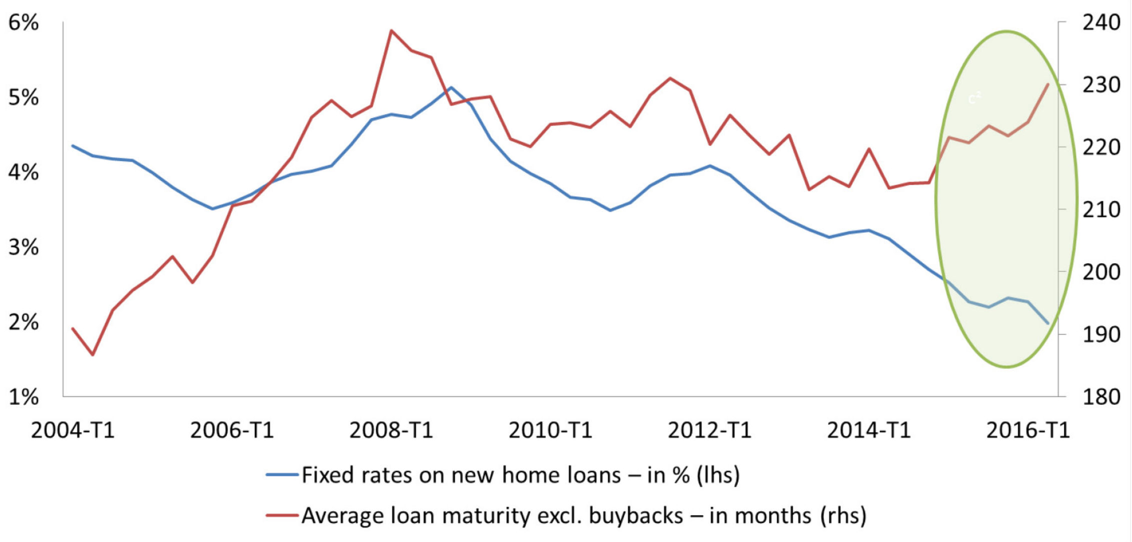
Sources: Banque de France ; INSEE and author's calculations.

Despite unfavourable economic conditions, this increase has contributed to the relative stability of the real estate price index since 2012. The signs of a recovery in the housing market over the past year, both the rise in housing starts and the price dynamics of existing dwellings, are linked to this rise in households' borrowing capacity.

Lower rates and longer loan maturities: the two drivers of this increase

Two factors have led to this significant increase in households' borrowing capacity over the recent period. On the one hand, the decline in interest rates: the fixed rates on new home loans were on average close to 2% in the second quarter (Q2) 2016 against almost 2.35% a year earlier and 3.2% in Q1 2014 (blue curve in Chart 3). On the other, the significant rise in average loan maturities: 230 months in Q2 2016 against 220 months in Q1 2014 (red curve).

Chart 3: Drop in interest rates and rise in loan maturities



Sources: Banque de France.

Will this increase in borrowing capacity continue? The historically low level of interest rates and the already significant lengthening of loan maturities have already produced their effects, but income developments could take over.

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