Stefan Gerlach: Making residential rental markets work for financial stability

Address by Mr Stefan Gerlach, Deputy Governor (Central Banking) of the Central Bank of Ireland, at the Twenty-First Dubrovnik Economic Conference, Dubrovnik, 8 June 2015.

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Accompanying charts can be found on the Central Bank of Ireland's website.

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1. Introduction

I am very pleased to be here in Dubrovnik at the 21st Dubrovnik Economic Conference.

Today I will talk about rental markets and financial stability. While the rental market is currently a focus of attention in many countries, including Ireland[1], the link with financial stability, a preoccupation of central banks, is an issue that is frequently neglected in the important public debate about housing. Before proceeding, I note that while housing policies are outside the remit of central banks, any financial stability concerns they raise are not. In this talk, I therefore hope to draw attention to these issues, while recognising that it is for others to set specific policies in these areas.

My talk is motivated by three observations on housing markets through the crisis: first, while owner-occupancy rates increased prior to the crisis, during the recent crisis we saw owner-occupancy rates fall. Consequently, the number of renters rose in many countries affected by housing market downturns, including Ireland. This indicates that for many people of household formation age, the rental market acts as a backstop, which they turn to in times of uncertainty and tight credit conditions.

My second observation is that empirical evidence shows that economies in which the rental market was relatively large and deep suffered less during the financial crisis. Deep rental markets thus appear to promote the resilience of the economy to adverse shocks and are therefore desirable from an economic stability perspective. To promote their development, it is important that renting is an attractive long-term proposition for households and landlords alike.

My third and final observation arises from the fact that, as the economy recovered in Ireland, the housing market took off rapidly, with property prices increasing by over 20 per cent in 2014, having fallen by more than 12 per cent just two years earlier (indeed, in January 2015, the Central Bank of Ireland introduced loan-to-value and loan-to-income limits to increase the resilience of the banking and household sectors to the property market and to reduce the risk of bank credit and house price spirals from developing in the future).[2] This pick-up is often attributed to "pent-up" demand for owner-occupied housing which built-up during the crisis years when credit was scarce and there was uncertainty about the path of house prices.[3] Whatever its causes, it indicates that, while people are willing to rent on a short-term basis, there is a strong preference for owner-occupied housing over rented accommodation.

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1 See, in particular, the recent report by the National Economic and Social Council (NESC (2015)).

2 See Central Bank of Ireland press release and associated documentation, 27 January 2015.

3 The effect has also been exacerbated by the low levels of new house building during the crisis years, which has resulted in local supply shortages.

2. The financial crisis

To put the role of the housing market in perspective, it is useful to start by reviewing the depth of the recent economic crisis. One measure of the adversity of outcomes is the loss of potential output, shown in Chart 1 for a sample of 24 countries.[4] These losses arose from the crisis reducing the level and perhaps also the growth rate of the economy's productive potential. Another measure is the increase in the unemployment rate between 2005 and 2014, shown for a sample of 19 countries in Chart 2. Furthermore, Chart 3 indicates that there is a high correlation between output losses and house price declines. Those countries that experienced the greatest losses had the largest house price decreases after the crisis.

These charts illustrate that Croatia and Ireland both fared particularly poorly in the crisis: they experienced large losses of potential output, large increases in unemployment and large falls in real property prices. They also make clear that there are great differences between countries in economic outcomes.

While the travails of Croatia and Ireland might simply have been due to bad luck, credit-fuelled housing bubbles played a big part in both countries' pre-crisis growth and subsequent decline. It is this aspect that I will focus on and, in particular, the role that deep and well-developed rental markets can play in helping to reduce the effects of shocks to housing markets.

3. What is the role of rental markets?

So what is the role of rental markets in the downturn? As shown by Chart 4, the proportion of the population which rents property, that is the rental rate, varies among industrialised economies from just over 60 per cent in Switzerland to under 20 per cent in Spain and Croatia.[5] The rental rate is low in all English-speaking countries, ranging from 36 per cent in Canada to 26 per cent in Ireland. Indeed, rental rates increased in a number of countries that experienced housing market turmoil during the crisis years.

Consider a simplified scenario where all people in an economy finish school at 18, save for 10 years and then buy a house. In this scenario, a predictable number of people enter the housing market every year: those who turn 28 years of age.[6] When a shock hits the economy, house purchase is delayed, either because of uncertainty about the future direction of house prices, or because of a lack of credit. This delay in house purchase results in people moving into the rental market. A deep rental market is better placed to absorb such an increase in demand than a thin rental market. This is because the increase in demand will be a smaller portion of the overall size of the market.

Moreover, compared to a situation in which no new household formation takes place in times of uncertainty, this switch in preferences from owner-occupancy to rented accommodation can have an important stabilising effect on housing markets. As house prices fall and demand for rental properties pushes up rents, yields on rental properties increase, making it attractive to become a landlord instead of selling at a depressed price. In Ireland, it is estimated that 36 per cent of landlords are "accidental landlords" who found themselves with a property that they could not sell as a result of the housing market crash.[7] Rent received on these properties has enabled landlords to meet outstanding mortgage repayments, and thus helped them avoid falling into mortgage arrears. Moreover, as prices fall, the rental yield on a

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[4] These losses are computed by Ball (2014).

[5] Due to limited cross-country data availability, rental rate data include households in both private and publicly-provided rental accommodation.

[6] See Miles (2011) for a discussion of such effects.

[7] RedC Survey results reported in Housing Agency (2014).

property is likely to rise, encouraging new landlords into the market and helping to create a floor to house prices.

Overall, a deep and well-established rental market therefore seems to be a mitigant against the effect of shocks to the broader economy and housing markets. This is clear in cross-country data. Chart 5 contains a scatterplot of losses in potential output during the crisis against rental rates and Chart 6 shows the relationship between rental rates and changes in unemployment. In both these cases a clear negative relationship is readily apparent. Overall, the evidence suggests that there is a link between the depth of the rental market and the severity of macroeconomic outcomes during the recent crisis.

4. The role of mortgage debt in a financial crisis

There are of course also a number of social benefits from owner-occupancy which need to be kept in mind. For instance, owner-occupancy represents the purchase of an asset and, since mortgage loans are amortised in Ireland, therefore leads to wealth accumulation. This can be particularly helpful in retirement, when reduced income can be offset by the lower cost of outright ownership of housing. In addition, studies have shown that homeowners are more engaged in social and political activities, have more positive assessments of their neighbourhoods, better psychological health and higher educational attainments.[8] Surveys in the US show that homeowners believe their neighbourhoods are safer and better places to raise children.[9]

But while the benefits of owner-occupancy are well documented, there is a much less well-known flipside to this coin: the risks associated with financially vulnerable households taking on the financial burden of house purchase. Let me now discuss this issue.

In Ireland the burden of the current crisis has fallen squarely on the young, many of whom bought property at the top of the market. The perception that one must get "on the property ladder" as soon as possible that was a particular feature of the boom years, but also a consequence of the poorly functioning rental market in Ireland, has had implications for younger families. Many of these are now left with unsuitable properties for their housing needs (for example, one bedroom apartments that are not satisfactory for growing families), and with debts that they could no longer service when salaries declined and unemployment rose during the economic downturn. Moreover, negative equity and mortgage arrears may make it difficult for them to move in pursuit of new, or better paid, employment. While desirable and beneficial for many, homeownership does come together with important risks that many neglected before the onset of the crisis.

A particular concern in this regard is the fact that the risk of becoming unemployed or experiencing income losses is not evenly shared across society. Younger and less experienced workers, and those who work in industries that are sensitive to the business cycle, such as the construction sector, are particularly exposed to the risk of unemployment.

This is illustrated by Chart 7 which shows that the crisis has disproportionately affected unemployment rates among younger age cohorts in Ireland. Graduate salaries have declined significantly since 2007, which has long-term implications for the earning potential of young people.[10] Chart 8 shows that employment in the sectors most vulnerable to the economic cycle, such as construction, has been most adversely affected by the crisis.

Thus, the lack of a deep and well-functioning rental market forces all households, including those at a relatively high risk of unemployment, into the property market. While the great

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[8] See Rohe and Lindblad (2013) for a discussion of the benefits of homeownership.

[9] See Belsky (2013).

[10] Conefrey and Smith (2014).

majority of borrowers are credit worthy and will service their loans, unemployment and income loss, which may be caused by the unemployment of a spouse or partner, have been important determinants of mortgage arrears in Ireland.[11] Banks in economies with very high house ownership rates may therefore experience high credit losses in a downturn.

The resulting link between highly-indebted and financially more vulnerable households and the banking sector can create a cycle which is both self-reinforcing in good times with expectations of increasing capital values increasing equity and enabling greater indebtedness, and in bad times as both banks and households suffer losses.

What role can rental markets play? Buying a house using a mortgage is a risky leveraged investment that involves a household borrowing several times its annual income to buy an asset with an uncertain future value. Such investments should only be entered into by those that understand the risks and feel able to assume them. Moreover, the rental market can alleviate the risk of capital loss and negative equity, increase labour mobility and thus facilitate the adjustment following adverse economic shocks. From a financial stability perspective it is therefore important that households that worry about the risks of homeownership have the option, if they wish, to rent a property that provides the type and quality of housing, and security of tenure, that they require. Let me next turn to the rental market.

5. The private rental market

It is clear that in Ireland, in contrast to elsewhere in Europe, renting a home is not seen as a long-term option for households. Indeed, results from a recent survey show that over 70 per cent of private rental tenants would prefer to own their own property, and just 17 per cent wish to rent long-term.[12] While this may reflect a cultural preference, or the benefits of homeownership, it seems more than likely that the type, quality, affordability and, in particular, security of tenure of private rented accommodation also plays an important role.

What can be done to make renting a more attractive long-term alternative to homeownership? I believe that there are three aspects to this problem: first, the rental market structure, particularly in terms of security of tenure, can play a role. Second, the investment horizons of landlords are important. A culture whereby the market is dominated by landlords seeking an income stream over the long term, rather than a capital gain in the short run, can help raise the attractiveness of renting in a number of ways. Finally, in many countries, policies aim to specifically incentivise homeownership, to the detriment of the rental market.

5.1 Security of tenure

A particular concern in Ireland is the absence of long-term rental contracts; while households may wish to stay for long periods in their accommodation, rental contracts in Ireland are predominantly of a year's duration. This leads to a wide-spread lack of security of tenure. Indeed, a recent survey indicated that 23 per cent of private tenants in Ireland are afraid of losing their home. In addition, 32 per cent have no formal lease, even though more than half have been living in their current accommodation for more than two years.[13] The risk and the associated costs of having to move may make households opt to purchase their own home and take on financial risks that they may feel they are not well placed to assume. Indeed, 29 per cent of tenants say that they would be more likely to rent long term if there was the possibility of a longer term lease.[14] Lengthening rental contracts therefore seems desirable.[15]

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[11] McCarthy (2014).

[12] RedC survey reported Housing Agency (2014).

[13] Housing sentiment survey conducted by iREACH, reported in NABCO (2014).

[14] Housing Agency (2014).

Interestingly, research has shown that in countries with comparatively strong security of tenure and high rental rates, such as Germany and the Netherlands, security of tenure is seen to foster long-run demand for renting and rental investment, such that neither tenants nor landlords have sought to weaken security.[16]

Why are rental contracts in Ireland of such short term nature? Ireland's history of high and variable inflation and the lack of institutional investors in the rental market must both be important. In economies with a history of inflation, banks protect themselves by lending at flexible interest rates. In turn, with mortgage costs varying over time, renters protect themselves with short term contracts. In contrast, in economies with a history of low and stable inflation, mortgage lending tends to be for long maturities and rental contracts tend to be longer term.

Of course, Ireland's history of inflation is now over. But lending arrangements change slowly. Overall, housing markets and financial stability in Ireland would benefit from borrowers having a wider choice of fixed rate loans.

5.2 Incentives of landlords

The lack of institutional investors in the rental market is also important. The Irish rental market is dominated by private households who let a single property.[17] The fact that they may need the dwelling for a family member, or may wish to sell it, is another factor that makes for short-term contracts and concerns about the security of tenure. Furthermore, buy-to-let properties have the highest rate of mortgage arrears. The latest figures from December 2014 show that over 25 per cent of buy-to-let mortgages are in arrears. Indeed, survey findings suggest almost 50 per cent of all landlords[18] cannot cover their loan repayments with rental income. Overall, 29 per cent of landlords intend to exit the market as soon as possible.[19]

In contrast, institutional investors, such as pension funds and insurance companies, have very long investment horizons and have strong preferences for tenants who stay for an extended period of time, since finding new tenants and refurbishing apartments for them is costly.[20] Institutional investors can bring a standardised, professional approach to the management of entire buildings of apartments, aiding the supply of suitable accommodation in popular areas. This suggests that attracting more institutional investors would promote a well-functioning rental market that is so important for financial stability.[21] Furthermore, these investors are likely to be less leveraged and have more diversified portfolios than individuals owning one or two rental properties, and are thus better able to withstand an economic downturn.

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15 NESC (2015) discusses security of tenure in depth.

16 See De Boer and Bitetti (2014).

17 See Housing Agency (2014) which suggests that over 80 per cent of landlords own one or two properties.

18 Including those without outstanding debts.

19 Housing Agency (2014).

20 As do private households that invest in property for purposes such as additional income in retirement. In Germany, where many people rent for extended periods, a large share of landlords are individuals, however, they do so for retirement purposes rather than capital gains, and are therefore interested in a steady income stream from long-term tenants (see ECB (2009), particularly Box 3).

21 To this end, Budget 2013 introduced Real Estate Investment Trusts (REITs) to Ireland. To date, approximately 1,500 residential units have been acquired by REITs.

There is a wide variety of government intervention in rental market, from the direct provision of social housing to the regulation of the private rented sector.[22] Because moving is costly and disruptive, the tenant-landlord relationship is inherently asymmetric. Regulation, if designed well, can therefore improve outcomes. That said, poorly thought out regulation, in particular rent controls, can have adverse effects by reducing the supply of rental properties and discouraging new construction and the maintenance of existing rental properties. Getting housing regulation "right" – a task outside the central bank's remit – is important.

5.3 Policies favouring home-ownership

Home-ownership brings many benefits, and it is understandable that there are policies in place to enable house purchase; I have already outlined the potential benefits in terms of asset accumulation and social advantages associated with home-ownership. However, some policies aimed at enabling people to gain from the benefits of home-ownership have the effect of worsening the situation of those who either choose not to be homeowners, or cannot afford to be so.

One important issue that influences households' choices between buying and renting property is tax policy. In many countries it is generally favourable towards homeownership. Examples of favourable taxation treatment of housing include the exemption of imputed rental income on principal homes from income tax calculations, tax relief of mortgage interest payments, exemptions of capital gains from the sale of principal homes, and the use of outdated housing values for property taxes.

A favourable tax treatment of homeownership risks encouraging excessive leverage and housing investment, leading to the development of macroeconomic and financial imbalances.[23] It can also tempt households that are worried about the risks inherent in mortgage borrowing into house ownership. Overall, it seems desirable for tax policy to be neutral between homeownership and renting. To this end, it is important to note that tax relief on mortgage payments have been phased out since the crisis, and a recurrent property tax has been introduced, in Ireland.

6. Conclusion

Economies that experienced boom-bust cycles in housing, such as Croatia and Ireland, suffered disproportionately in the financial crisis. There were numerous reasons for this large impact, many of which are, by now, very familiar. However, it is less frequently noted that those economies with deeper rental markets suffered less. While the specifics of housing policy are outside the remit of central banks, it is incumbent for us to draw attention to issues that relate to financial stability. To reduce the risk and the amplitude of future housing cycles, housing policy needs to consider also financial stability issues. In this regard, it seems particularly important to promote a well-developed rental market as a genuine alternative to ownership, and an attractive investment proposition for potential landlords. While many households may continue to buy rather than rent, we need to make sure that this choice reflects their preferences and does not merely reflect a poorly functioning rental market.

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