

Trends in the borrowing pattern of French households

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A great deal of attention has been paid to trends in French households' financial behaviour as the sector has been the main contributor to the bank retail market growth over the recent years. It appears that loan-by-loan data are very useful in order to assess the sustainability of the recent increase in household debt while macro-economic statistics provide more conflicting evidence on the soundness of household financial position.

1. Strong dynamics in French household debt

As in other OECD member countries, French household debt has steeply increased in recent years. As a result, the ratio of the household debt to the GDP, as measured in financial accounts, has steadily risen since 1998 from 33.5% to 43.2% at the end of 2005 and to 44.7% by mid 2006. During the same period, non financial corporation debts remained stable and accounted for 55% of the GDP by the end of 2005.

This development in household debt mainly reflects the rise in the growth rates of loans granted by credit institutions. According to monetary statistics, they rose from 1.8% in 1994 to 11.7% in 2005. While consumer loans post lower and more volatile growth rates, housing loans have been the main contributor to the acceleration of loans to households. Excepting the plateau reached between 2000 and 2002, the housing loans contributions kept on increasing over the whole period.

As from the beginning of 2006, housing loan growth rate seems to level off at around 15%. The quarterly bank lending survey conducted by the Banque de France confirms that the demand for loans has tended to strengthen somewhat during the year while stabilization was expected at the end of the period².

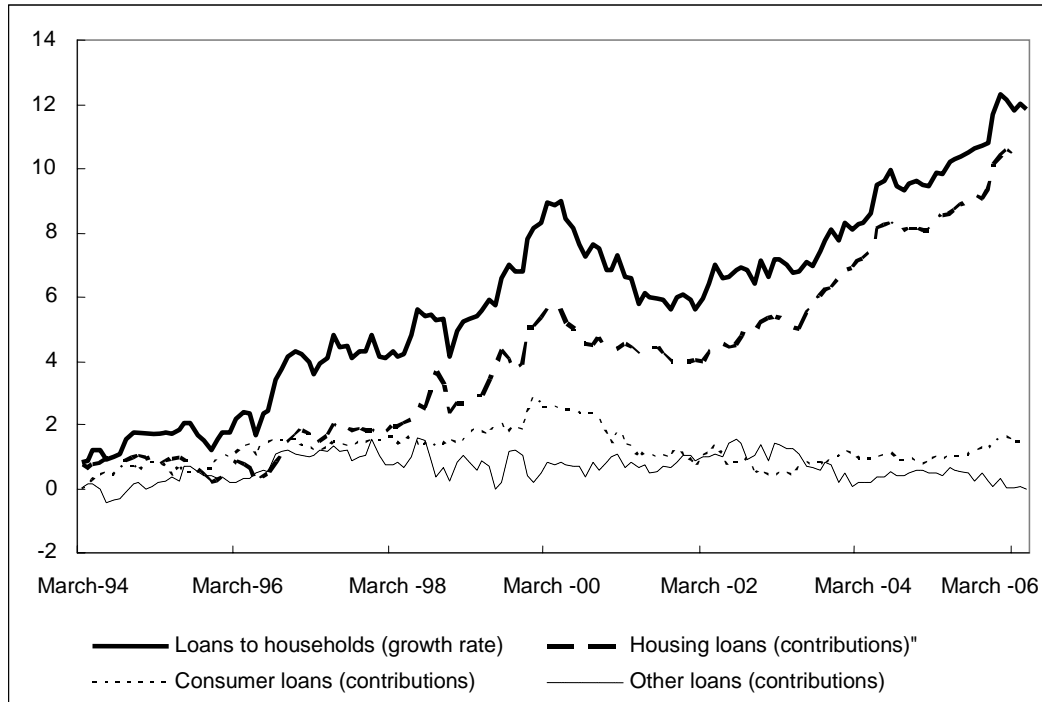
In real terms, the current growth rate of housing loans is well above the average value observed between 1970 and nowadays and is only comparable to the peak reached during the seventies (Wilhelm, 2005³). However, the current boom is without precedence for two reasons:

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² The bank lending survey is a quarterly survey conducted by national central banks of the Eurosystem. The main objective of the survey is to enhance the Eurosystem's knowledge of financing conditions in the euro area and hence to help the Governing Council of the ECB to assess monetary and economic developments as an input into monetary policy decisions. It is designed to complement existing statistics on retail bank interest rates and credit with information on supply and demand conditions in the euro area credit markets and the lending policies of euro area banks. The survey addresses issues such as credit standards for approving loans as well as credit terms and conditions applied to enterprises and households. It also asks for an assessment of the conditions affecting credit demand. See <http://www.ecb.int/stats/money/lend/html/index.en.html#results> for the results at the euro area level and http://www.banque-france.fr/fr/stat_conjoncture/stat_mone/page6b.htm for the French results.

³ See http://www.banque-france.fr/fr/publications/telechar/bulletin/etu140_2.pdf.

Loans by purpose: contributions to the total annual growth rate



Source and calculation: Banque de France's money and banking statistics.

- Its duration and its resilience to the economic slowdown which has taken place as from 2000⁴.
- Its relative disconnection with gross fixed capital formation in dwellings as nearly two thirds of new loans are dedicated to transactions on existing real assets. In 2005, they accounted for 63.2% of the volume of new loans while loans dedicated to new houses accounted for 29.8% of the total and loans to house improvement 6.7% (Banque de France, 2006)⁵. This reflects the quite slow adjustment of the supply of housing to the rise in the demand, which itself explains the rise in construction prices noticed as from 2002.

The demand for housing has indeed been fuelled by the continuing increase in the number of households in connection with the growing population and the increase in the number of families. Besides, French households take into account the relative high opportunity cost of renting instead of buying, in particular because French legislation allows rent to be indexed on the construction prices⁶. They also generally feel that investment in housing is both profitable and secured specially with the view to preparing for retirement.

⁴ The annual growth rate of GDP went from 4.0 % in 2000 to 1.9 % in 2001, 1.0 % in 2002, 1.1 % in 2003, 2.3 % in 2004 and 1.2 % in 2005.

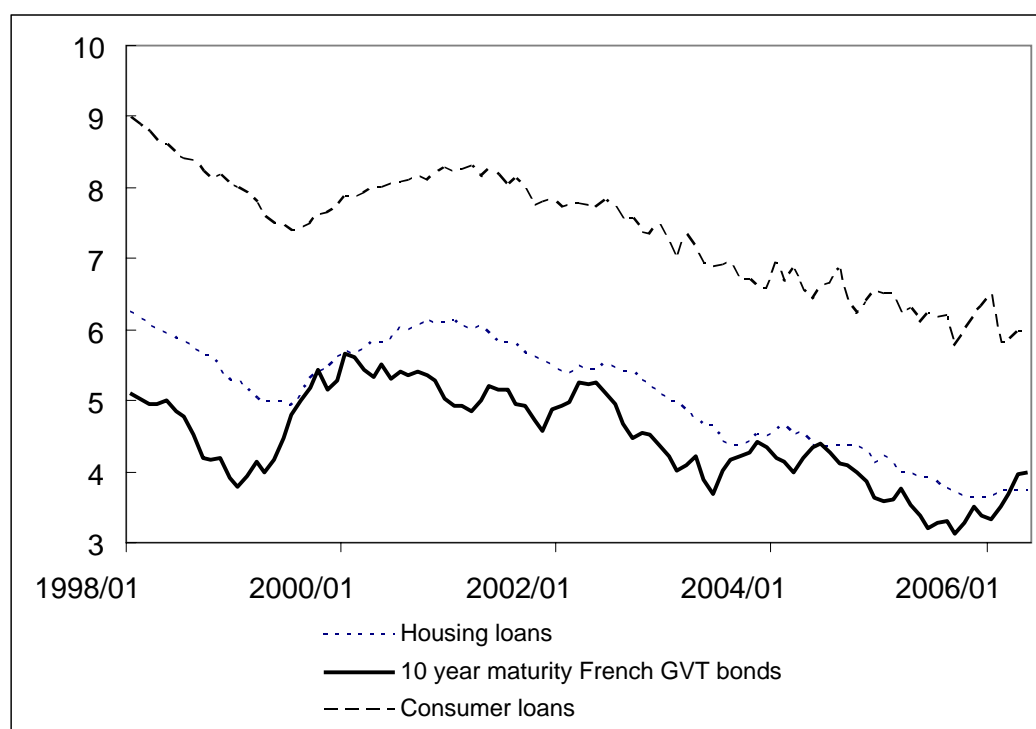
⁵ See http://www.banque-france.fr/fr/publications/telechar/bulletin/etu150_5.pdf.

⁶ In order to curb the inflation on rents due to this indexation, the reference to construction prices was repealed at the beginning of 2006 and replaced by a specific composite index in which the consumer price index weight amounts to 60 % (see http://www.insee.fr/fr/indicateur/indic_conj/donnees/method_idconj_35.pdf).

At the same time, banks seem to have been quite proactive in the financing of the housing transactions. Indeed, risks related to them are very low and will soon be reflected in the related prudential own funds requirements after the implementation of the new Basel II solvency regime. At the same time, granting housing loans might be a way of stabilizing or even locking in the relationship with the retail customers and bundling with the financing of other financial products.

However, the key factor at the origin of the current boom in housing loans has certainly been the decline in lending rates as from the end of the nineties. For instance, interest rates on loans with an over 10 year initial period fixation went down from 5.3% at the end of 1998 to 3.6%. Strong competition between lenders narrows the spread with market rates and in some period households were able to borrow at conditions similar to those obtained by the French Treasury (see graph below). Since the end of 2005, lending rates have clearly lagged rising long-term market rates: between September 2005 and September 2006 yields on 10 year maturity French government bonds increased from 3.13% to 3.77% while the interest rates on fixed term housing loans gradually increased from 3.59% to 3.91%.

Interest rates on new loans to households



Source and calculation: Banque de France's statistics on monetary interest rates (MIR).

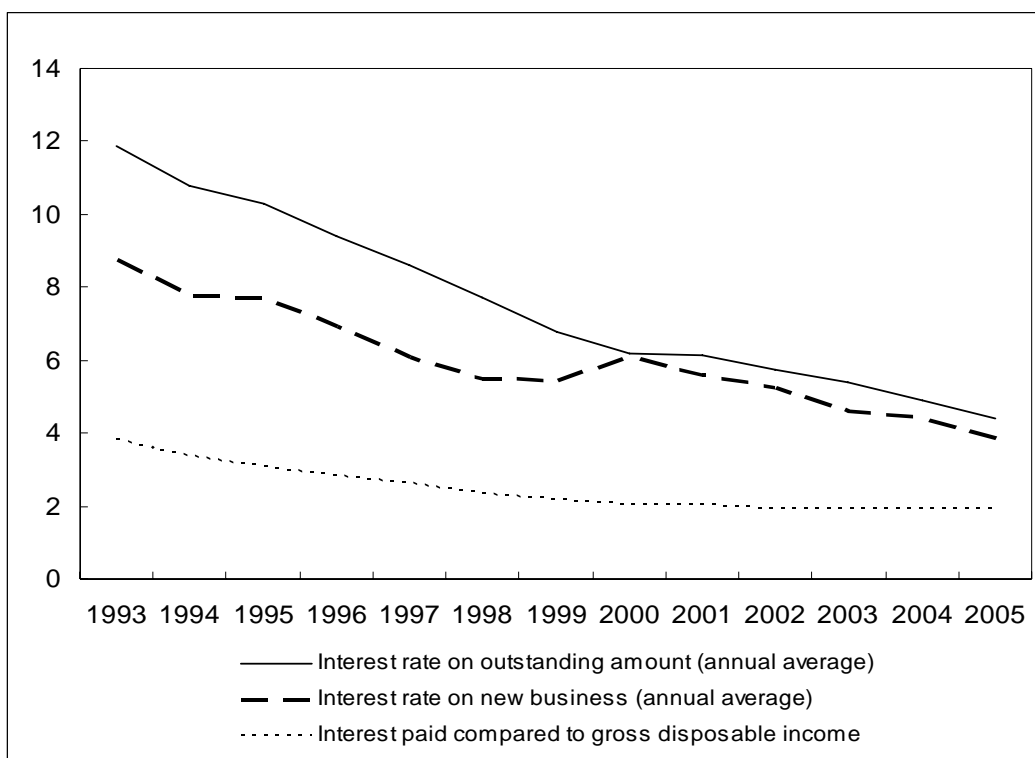
2. Unclear macro-economic evidence on household financial position

Such a continuous inflow of debts leads to the questioning of the soundness of the household financial position at the current juncture. In this regard, indicators using GDP as scaling factor could be misleading as they provide no indication regarding the weight of debt servicing on households' income, both in principal and interest. This remark seems to be highly relevant in the French case as the duration of new housing loans has markedly increased over the last years (see below).

A first answer can be provided looking at the impact of the payment of interests on household disposable income. According to the new interest rates statistics on outstanding amount, the annual average of implicit interest rates on housing loans (ie. the ratio of flows of interests as recorded in credit institutions' income statements divided by the average stock) dwindled between 1993 and 1999 from 11.8% to 6.7%. Since then, it has been slowly decreasing before reaching 4.4% in 2005.

As shown by the narrowing of the margin between interest rates on new business and interest rates on outstanding amounts, this development partly reflects substantial adjustments on the conditions on existing loans. Indeed, while the bulk of them are on fixed term, the French national legislation allows early repayments and caps the fees which can be charged by the lenders in the case of early redemption ⁷. For housing loans, for instance, these fees cannot exceed 3% of the remaining principal and are forbidden for consumer credit with an initial amount less than 21500 euros ⁸.

Interest rates and interest paid by households



Source: Banque de France's MIR statistics.

As can be seen from the chart above, the flow of interest paid by households compared to their gross disposable income has thus decreased during the same period (considering only housing loans, it amounted to 3.80% in 1993, 2.16% in 1999 and 1.93% in 2005) and amounted to 3.0% of gross disposable income in 2005. The question could then be why

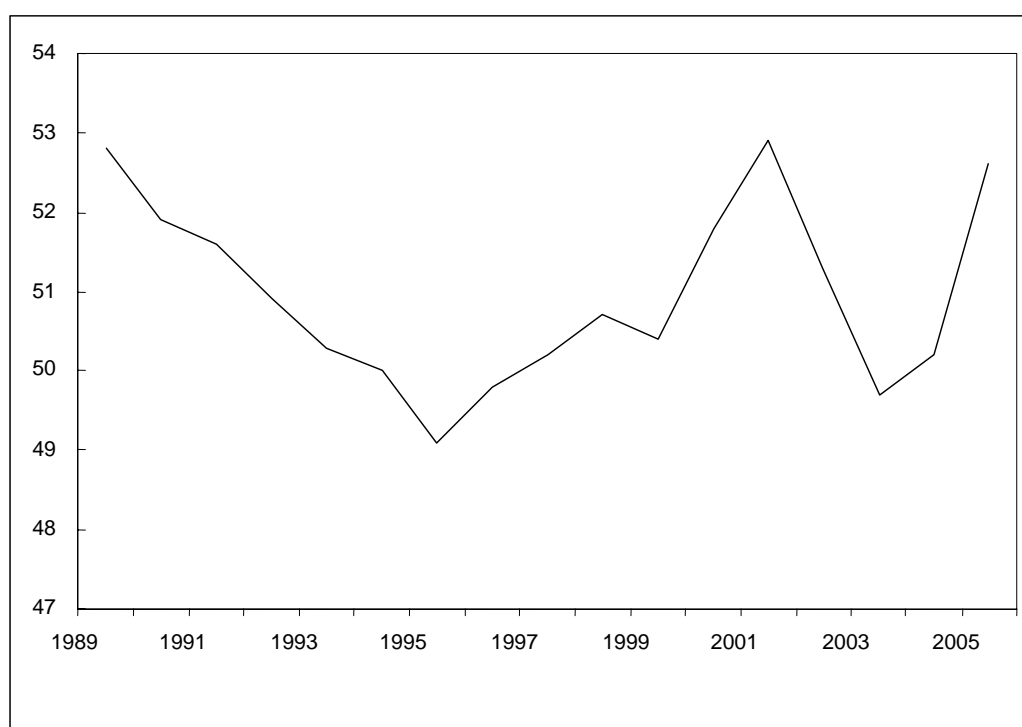
⁷ At the end of 2005, the share of fixed term loans granted by credit institutions to households amounted to 78.5% and to 81.2% regarding housing loans.

⁸ Articles L311-29 and D311 of the "Code de la consommation" regarding consumer credit and articles L312-21 and R312-2 see the French government official site: <http://www.legifrance.gouv.fr>.

households have not borrowed more. One answer could be that, referring to the life cycle hypothesis, pessimistic expectations on their future income or the ageing of the population has dampened the demand for loans⁹.

Moreover, the strong dynamics in French household debt should be seen in its European context (see the report of the CCSF, 2004¹⁰). Indeed, the growth rate of its banking component just equals the European average while Spain has constantly posted substantially higher growth rates over the last years (for instance, it grew by 12.0% in September 2005 on an annual basis in France and by 22.3% in Spain at the same date). A debt survey carried out on a panel of households by the “Observatoire de l’endettement des ménages” on behalf of the French Banks professional association confirms that the share of indebted households has not significantly changed since 1989 in France¹¹.

**Share of indebted households
(annual survey based on a panel of households - in percentage)**



Source: Observatoire de l’endettement des ménages 18ième rapport mars 2006.

The restrictive impact of the French legislation on usury rates on the supply of loans, exacerbated in the context of low market rates, is often suggested to explain the small of use of debts by a large part of the population, as it makes banks unable to charge higher risk

⁹ The share of people aged between 30 and 49 in the working population declined from 58.3 in 1995 to 55.4 % in 2005 while the one of people aged between 50 and 64 expanded from 15.4 to 20.8 (see 2006 Claude Minni “Structure et évolution de la population active selon l’âge” http://www.insee.fr/fr/ffc/docs_ffc/DONSOC06b.PDF).

¹⁰ See http://www.banque-france.fr/fr/publications/telechar/bulletin/etu144_2.pdf.

¹¹ See: [http://www.fbf.fr/web/internet/content_particuliers.nsf/\(WebPageList\)/AEF1720671229E11C1256EAD0031D9DF](http://www.fbf.fr/web/internet/content_particuliers.nsf/(WebPageList)/AEF1720671229E11C1256EAD0031D9DF).

premium¹². Indeed, usury rates are defined by law as 4/3 of the (simple) average interest rates compiled each quarter by the Banque de France on the basis of data collected from banks. However, different usury rates are calculated depending on the purpose and the amount of loans in order to take into account the difference in terms of risks between the different types of banking loans, in particular between housing loans and consumer credit. All in all, six different categories are in use. Besides, leasing is not covered by usury legislation.

3. What can be learnt from loan-by-loan data?

The quarterly loan-by-loan reporting on new business (QLBLR) was introduced by the Banque de France in 1985 in the wake of the deregulation of the financing of the economy. The idea was to have some insights into the changes in market lending rates by collecting individual information from a limited sample of branches and specialized credit institutions. It has been used for the calculation of usury rates since 1990. As from the beginning of 2003 and for checking purposes, the QLBLR was also made fully consistent with the new harmonised Eurosystem statistics on interest rates (hereafter called MIR statistics). Consequently, the same sample and the same definition of new business is applied, except in the case of overdrafts, which are defined as authorizations in the QLBLR and as utilization in MIR statistics.

As a result, the coverage of the QLBLR has been markedly expanded to meet the objective of accuracy of 10 basis points on average. The reference period is now the whole first month of each quarter, instead of the first two weeks, while the size of the sample has been significantly increased: in particular 3700 branches are now included, instead of 500 branches prior to 2003. For each loan covered by the QLBLR, banks are required to collect a number of variables such as, inter alia, the interest rate, the annual percentage rate of charge (APRC), the amount, the duration of the loan and the annual income of the borrower, as known by the lender¹³.

The interesting point about loan-by-loan data is that they allow the estimation of the distribution of interest rates at the level of the individual contracts and hence the extent of the truncation caused by usury rates. Lacroix (2005, internal) shows, by adjusting the observed cluster of interest rates to a combination of normal curves, that the impact of the legislation is marginal regarding housing loans but more effective regarding consumer credit of small amounts and personal loans.

The QLBLR also helps understand how the longer maturity of new housing loans has contributed to defuse the impact of buoyant housing prices on the service of household debts. Our findings are the following:

1. The average value of individual new loans grew in 2004 and 2005 at a pace similar to the one of housing prices. The latter increased by 25% during the period, according to an index based on indexes on construction prices and existing building prices weighted by the respective share of this two purposes in the new housing loans (respectively one third and two thirds, see section 1 of this paper). At the same time, the average value of "large" loans grew by 22.2% between January 2004 and January 2006¹⁴. Such a rise was also shown in the old QLBLR reporting, at

¹² See BABEAU 2005 http://www.banque-france.fr/ccsf/fr/publications/autres/menages_cred_consom.htm.

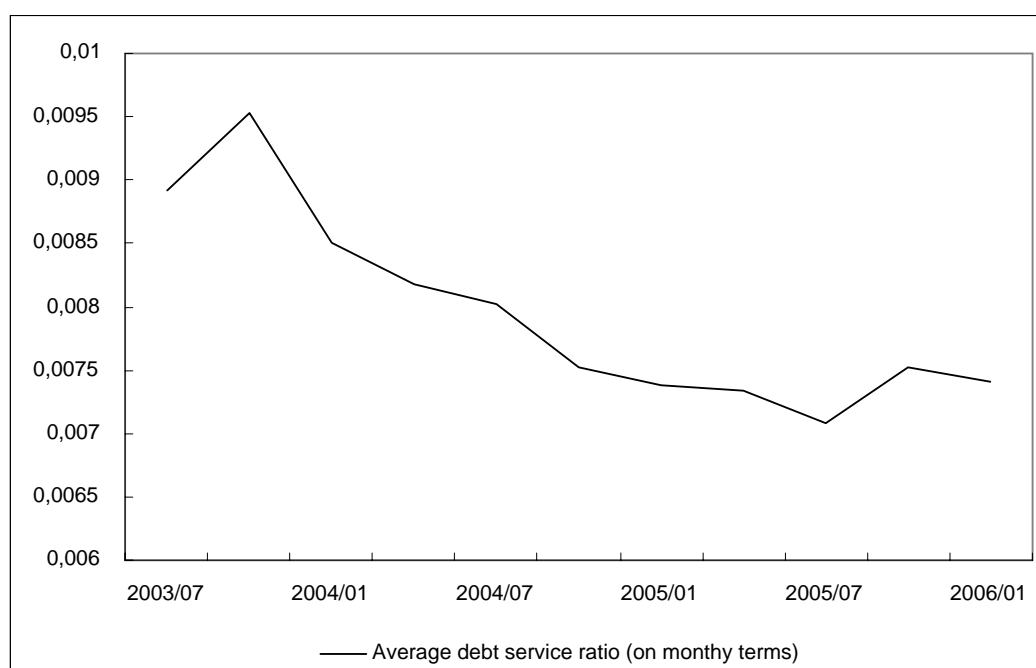
¹³ Detailed information regarding the methodology of the MIR statistics and the sampling is available on the BDF's web site: http://www.banque-france.fr/gb/stat_conjoncture/telechar/stat_mone/tibe.pdf.

¹⁴ "Large" loans are defined as loans with a value exceeding 95000 euros. They accounted for 50 % of the number of lines reported and accounted for 92.5 % of the total amount of new loans. "Small" loans are mainly dedicated to home improvement and the growth of their average value is rather unsteady and more limited (+ 3.1 % between January 2004 and January 2006).

least as from the end of the nineties. The dispersion of the individual amounts of these large new loans (in percentage of the average) only slightly increase over time, which reflects the development of very large loans (over EUR 450 000).

2. The number of lines reported relating to “large loans” increased by 28.7% between January 2004 and January 2006. This is broadly consistent with the development of the new business volumes during the same period, from EUR 76.1 billion in 2003 to EUR 120.4 billion in 2005 or + 58%, after adjusting for the rise in average value of transactions. The increase in the number of transactions could also be explained by early repayments of existing loans in connection with declining interest rates on new loans up to the end of 2005, as described above.
3. The average value of the redemption rate on new housing loans, defined as the amount of the instalment divided by the principal, has significantly decreased up to the middle of 2005 (from 0.85% in 2004 to 0.74% which amounts to a 22.4% decrease). This reflects a lengthening of the maturity of new loans, which is significant since the mid nineties. At the same time, the income of new borrowers slightly increased (+ 2.0% between 2004 and 2005).

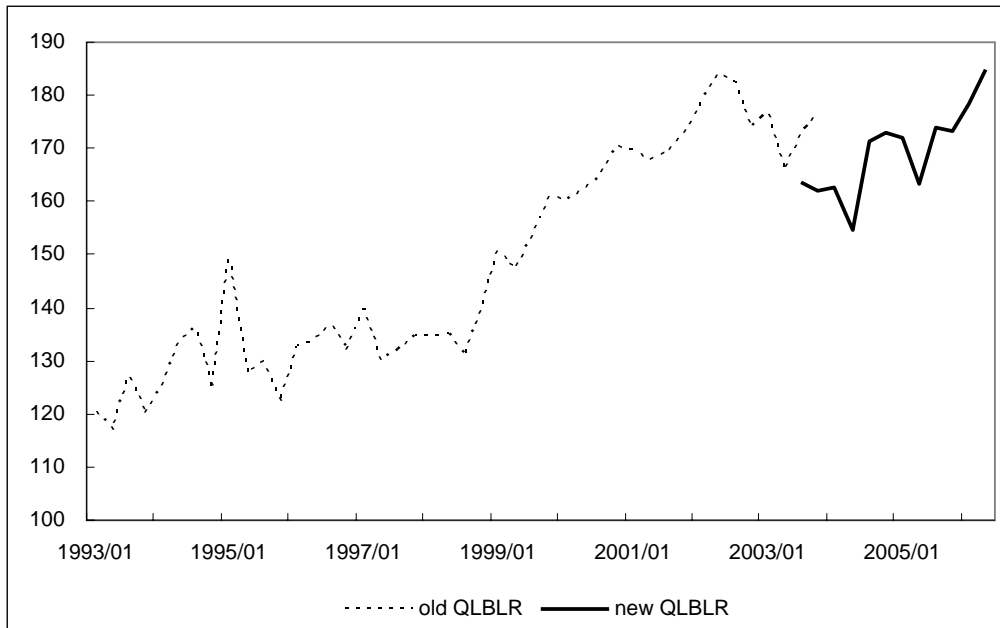
Average debt service ratio (on monthly terms)



Source and calculation: MIR statistics (QLBLR) and Banque de France.

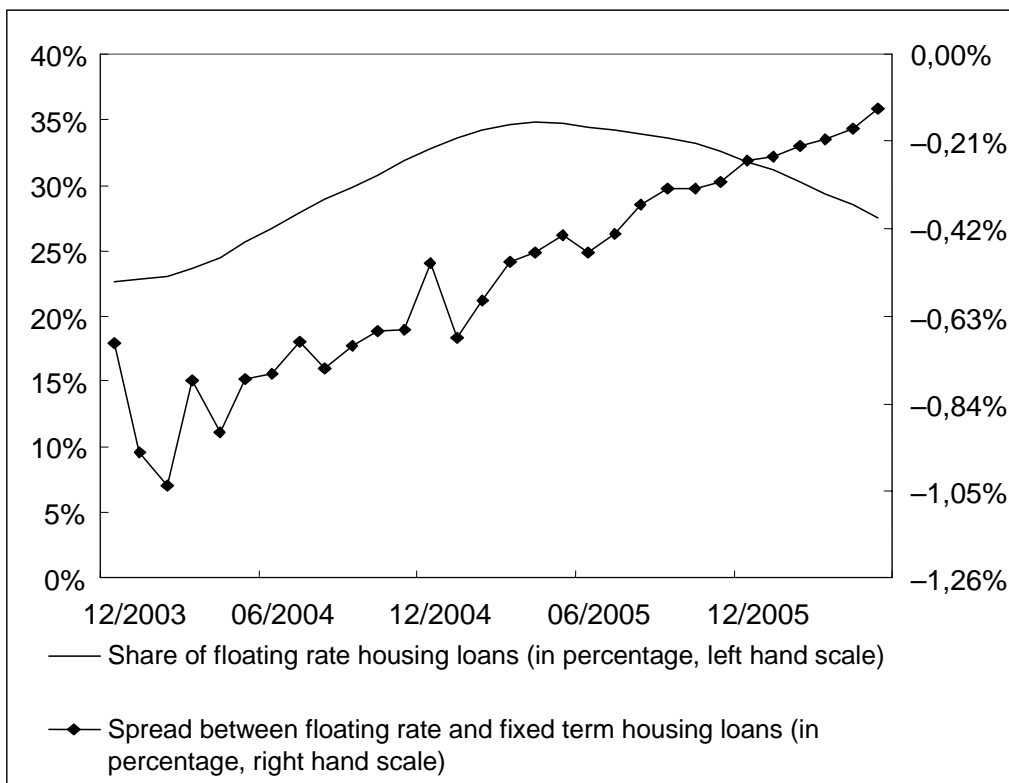
All in all, the debt service ratio on new loans seems to have remained stable or even to have somewhat eased. On the other hand, banks managed to sell more floating rate loans, the share of which in new housing loans peaked up to nearly 35% at the beginning of 2005, which is high by historical standards (less than 20% in the nineties). Households look to be less risk averse and the spread between fixed and floating rates have kept on narrowing. However, a substantial part of floating rates are capped in accordance with the loan contracts.

Duration of new loans



Source: MIR statistics (old and new QLBLR).

Share of floating rate housing loans



Source and calculation: Banque de France's MIR statistics.

4. Conclusion

The stabilization of debt service ratios on new loans due to very low lending rates and the lengthening of their maturity may explain why French households have been able to sustain the development of their debt over the last years. However, this favourable environment is changing because of rising interest rates and given the limits to the lengthening of loans (not least because recent fiscal and regulatory changes have substantially reduced long term deposits, such as housing saving schemes¹⁵). As a result, households might be more sensitive to the dynamics of housing prices in the future.

¹⁵ See Elizabeth Fonteny 2006: "les conséquences du changement de régime fiscal et social des PEL sur l'épargne logement » http://www.banque-france.fr/fr/publications/telechar/bulletin/etu153_3.pdf.