The Luxembourg market for housing finance

Defining characteristics

The bulk of residential mortgage loans in Luxembourg is granted by a limited number of credit institutions. The market has been characterised by a high degree of stability as few new competitors have entered. In addition to the “traditional” credit institutions, the “Bausparkassen” and the “Caisse de pension des employés privés” are also present.

Most institutions providing housing finance are incorporated as banks under Luxembourg law. It should be noted that two of the most important actors in housing finance are owned by foreign banks. Less than 6% of outstanding loans were granted to borrowers residing in other euro area countries. Anecdotal evidence suggests that institutions abroad account for very little housing finance in Luxembourg.

The commonest mortgage contract is at a variable rate. However, this does not necessarily represent a risk for the overall stability of financial institutions. Fixed rate products seem to have gained in importance recently. This could also be linked to the currently very low level of interest rates.

The standard maturity for mortgage loans is 20 to 25 years, while some banks grant credits for up to 40 years.

One of the banks with the largest market shares is state-owned. However, in practice it operates under the same legal conditions as any other commercial bank. The state subsidises households’ mortgage interest payments.

Main developments and trends over the past 10-15 years

Residential property price inflation has followed an upward trend since 1993, which marked the end of a period of declining house price inflation. The latest available data, for 2003, show that nominal house prices increased by 11.9%.

House price inflation was slightly outpaced by estimated growth in per capita disposable income. Affordability, as measured by the ratio of per capita disposable income to house prices, deteriorated between 1985 and 1990 and has recovered since then. However, it deteriorated markedly in 2003.

The increase in house prices depends to a large extent on the price of land available for construction purposes. Land is a scarce resource, so its cost increases with the growing number of households and with higher per capita disposable income. Local planning rules limit the land available for construction purposes.

The state took fiscal measures in 2002 to increase the supply of both housing and land for construction purposes. The impact of these measures on prices is still unclear.

Demand for loans for house purchase continued expanding in 2004 (11.4% growth on average) and in 2005 (11.3%), while moderating compared to 2003 (more than 20% growth). The increase in home loans may have contributed to strong house price dynamics in Luxembourg. The question is to what extent the strong credit growth could become a source of unsustainable price increases in property markets.

Rent increases were much more moderate than house price hikes. However, the residential rental sector is heavily regulated.

1. The housing market

1.1. Developments over the last 10 years in house prices, rent levels, disposable income, household debt and wealth

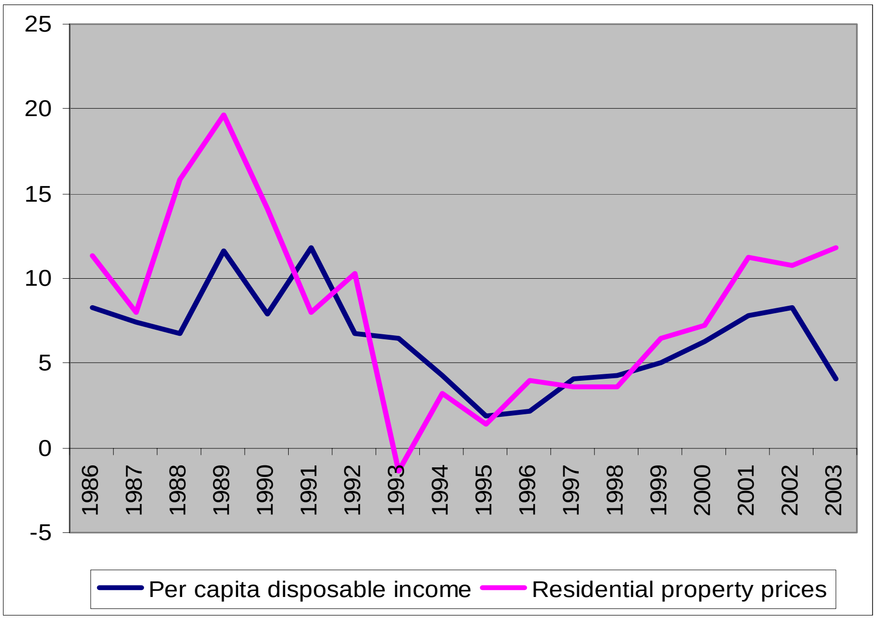
Residential property price changes have followed an upward trend since 1993. The annual rate of house price changes moderated from almost 20% in 1989 to –1.3% in 1993. The latest available data, for 2003, show that house prices increased by 11.9%. Partial evidence from a survey of newspaper and internet advertisements suggests that house prices increased by 7.2% in 2004, while apartment prices increased by 12.5%.

Growth in per capita disposable income[1] was outpaced by house price inflation (see graph). In fact, house price increases averaged 8.3% since 1986, while nominal disposable income grew at an average of 6.4% over the same period. Affordability, as measured by the ratio of per capita disposable income to house prices, deteriorated between 1985 and 1990 and has recovered since then. However, it deteriorated markedly in 2003.

Graph

Residential property prices and per capita disposable income

Annual percentage changes



Sources: STATEC; BCL calculations.

Yearly nominal house price fluctuations were volatile in Luxembourg over the period from 1985 to 2003, ranging between –1.3% and 19.7%. However, price changes are part of the normal functioning of the housing market and need not necessarily indicate "bubbles". Since the supply of new housing cannot respond rapidly to demand shocks, house prices may deviate from their fundamental/equilibrium value for prolonged periods of time.

The increase in house prices depends to a large extent on the price of land available for construction purposes. Land is a scarce resource, so its price increases with the growing number of households and increasing per capita disposable income. As local planning rules limit the land available for

[1] Household disposable income is not published in Luxembourg's national accounts. Here it is approximated by compensation of employees plus government transfers to households minus social contributions and direct taxes paid by households. Figures are adjusted for the significant number of non-residents in employment.

construction purposes, they have an impact on house prices. Some local authorities are reluctant to make land available for construction as new housing increases infrastructure costs (eg schools, roads, etc). The state took fiscal measures in 2002 to increase the supply of both housing and land for construction purposes (see point 1.3 below on registration taxes, capital gains taxes, real estate taxes and VAT). The impact of these measures on prices is still unclear in the absence of house price statistics for 2004 but partial evidence from a survey of newspaper and internet advertisements suggests that house prices have continued on their upward trend in 2004. However, government policy to provide housing at “affordable” prices does not seem to have triggered a significant decline in house price inflation.

Demand for housing loans continued expanding in 2004 (11.4% growth on average), while moderating compared to 2003, when these loans increased by more than 20%. The increase in housing loans may have contributed to strong house price dynamics in Luxembourg. The question is to what extent strong credit growth could become a source of unsustainable price increases in property markets. The very low level of interest rates is also likely to have fuelled recent demand for housing loans.

Rent increases were much more moderate than house price hikes, averaging 3.2% per year since 1986. However, the residential rental sector is heavily regulated.

The transformation of dwellings into commercial/office buildings has had a negative impact on the housing stock in some areas, particularly in Luxembourg City. This development has been driven by: (i) the fact that rents in the commercial sector are not regulated; and (ii) a gradual increase in the demand for office space in line with economic development in general and growth in the services sector in particular.

1.2. The extent of government influence in the housing market

The state aid regime enacted in 1979 distinguishes between individual and collective aid.

Individual aid is granted to households buying primary residences. A distinction can be made between capital grants, which are designed to help households accumulate sufficient starting capital (ie construction grants, home improvement grants, home purchase grants and savings premiums), and subsidies aimed at reducing monthly mortgage interest rate payments (ie interest allowance and interest subsidy). These subsidies are based on the income and family situation of the beneficiary and on the size of the dwelling. Some local authorities also grant public aid in addition to that from the central government.

Luxembourg authorities are active in supplying social housing, which is provided indirectly by public developers. The Eighth programme for the Subsidised Building of Housing Blocks involves the construction of 10,822 subsidised dwellings for both rental and sale.

The main public developers are the “Fonds pour le développement du logement et de l’habitat”, the “Société Nationale des Habitations à Bon Marché” (SNHBM), the “Fonds d’assainissement de la Cité Syrdall” and local authorities. The central government allocates funds to these public developers.

1.3. Regulation (tax laws, owner occupancy requirements, etc)

The law of 30 July 2002 enacts several tax measures which aim to reduce the shortage of building land and housing. The four most significant measures are:

- Registration tax (“droits d’enregistrement”) is payable when real estate property is bought. The tax base is the value of the transaction (or the “normal” market value in case of a significant difference from the transaction value), and the rate is 6% in most cases. However, a “taxe de transcription” equal to 1% of the value is also collected, which means that the effective rate is 7%. In addition, a special surcharge of 50% of the registration tax is applied for buildings sold in Luxembourg City (unless the building has been occupied for 10 years or more). This tax is likely to have penalised investment in housing compared to alternative assets like government bonds. It favours investment in dwellings under construction or in building sites as opposed to the acquisition of existing houses since the tax is calculated on the transaction value (which comprises the existing construction) at the time of the acquisition. In order to reduce the auxiliary costs associated with buying a dwelling, the law of 30 July 2002 introduced a tax credit on registration duties and fees for all persons wishing to acquire real estate property intended for dwelling purposes; this tax credit is set at EUR 20,000 for single persons and at EUR 40,000 for couples, independent of the amount of registration taxes. Any balance of the tax credit can be carried forward to a future acquisition.

- Value added tax: the 2002 law introduced the direct application of the "super-reduced" VAT rate (3%) on construction and renovation work; the former VAT repayment system is still applicable for those taxpayers who are not eligible for the direct application of the "super-reduced" VAT rate.
- Capital gains taxes on real estate. Only secondary residences are taxed. A favourable tax treatment is applied when real estate assets have been owned for more than two years. A tax allowance of EUR 49,600 is available for non-speculative capital gains on immovable assets. However, only one such allowance can be used by the taxpayer over a 10-year period. In 2002, the government reduced the tax rate applicable to capital gains realised on the sale of real estate from 50% to 25% of the average tax rate (the reduction also applies to the sale of land situated in a housing estate and to operations carried out by property developers). This measure is effective only from 2002 to 2007.
- Income tax: rents received are taxed at the marginal tax rate (rents paid are not deductible from personal taxable income). The 2002 law raised the accelerated amortisation rate on rented buildings from 4% to 6%. This accelerated rate is available for new buildings or renovation costs during the first five years. The depreciation allowance for dwellings older than 60 years is 3%. Interest paid on mortgage loans is considered costs related to rent income and can therefore be deducted in full from rent received. All other costs incurred in relation with rent income, such as "real estate management costs", can also be deducted from rent income. It should be noted that a negative rent income is offset against all other kinds of positive income, thereby moderating the overall tax due.

Other relevant features of the taxation framework are:

- Imputed rents for owner-occupied housing are also taxed at the marginal tax rate. However, the tax base is equal to 4% or 6% of the so-called "unit value" of the dwelling, which is much lower than the market value. Mortgage interest paid by owner-occupiers is deductible from their taxable income up to a certain threshold. The yearly ceiling for tax deduction amounts to EUR 1,500 per person living in the household for the first six years after moving in. This deduction is progressively reduced to EUR 750 for dwellings occupied for 12 years or longer. Mortgage interest on secondary homes is not tax-deductible.
- Real estate tax ("impôt foncier"). This tax is collected at the local level. Some properties are exempted from the tax, for instance: (i) properties owned by the state or by local authorities which are used to provide public services; (ii) properties owned by non-profit organisations; (iii) hospitals or buildings owned by religious orders when they are used for medical or educational purposes; (iv) properties such as the railway system. The taxation base is the unit value of the properties, which is based on a scale that dates back to 1941, multiplied by a coefficient that ranges between 0.7 and 1% depending on the nature of the property. Local municipalities fix the tax rate applied to this base. It varies considerably, from 90 to 800% of the base, depending on the type of property and the city where the property is located.

1.4. Transfer and enforcement of ownership/collateral rights

According to article 879 of the "Nouveau code de procédure civile", the lender can have the residential property sold by a notary public in case of the debtor's default without applying the legal procedures normally applicable to seizure of property, provided that the interested parties have agreed to this simplified procedure by means of a prior notarial act. Five months are usually required for payment to creditors under this simplified procedure. In the absence of a prior agreement to apply the simplified procedure laid down in article 879, the lender will use a procedure involving the court (enacted in the said code from article 809 onwards).

See also points 4.1 and 4.2 below.

1.5. Structure of housing tenure (rental/ownership, etc)

The great majority of households are owner-occupiers (about 70% in 2003). This share has increased in recent decades.

2. Borrowing and contract types

2.1. The relative importance of fixed and floating rate borrowing

Most mortgage contracts are at a variable rate, representing over 83% of new lending in 2003 and 2004. These statistics were not compiled previously. No breakdown of the stock of outstanding loans into fixed and variable interest rate loans is available. The relative importance of floating rate borrowing does not necessarily mean high risks for the overall stability of financial institutions, but they do render some households more vulnerable to variations in credit conditions, in particular if these are accompanied by income shocks and/or house price decreases.

2.2. Recent changes in the menu of products offered to borrowers

Despite the lack of statistics, it seems that fixed rate products have gained some importance over recent years. This could also be linked to the very low level of interest rates.

2.3. Segmentation of the housing finance market

The bulk of residential mortgage loans in Luxembourg are granted by a limited number of credit institutions. The market has been characterised by a high degree of stability as few new competitors have entered. Besides the "traditional" credit institutions, "Bausparkassen" (building societies) and the "Caisse de pension des employés privés" are also present. The latter institution lends at a lower interest rate, but only to private sector employees who contribute to the pension fund.

2.4. The typical maturity of mortgage loans

The standard maturity for mortgage loans is 20 to 25 years, while some banks grant credits for up to 40 years.

2.5. Prepayment and/or equity withdrawal conditions

While prepayment of floating rate loans is possible at any time without penalties, this is not the case for fixed rate loans. Formal equity withdrawal (ie mortgage-backed loans to finance current consumption and/or the purchase of financial assets) is not widely used. However, lenders take account of the value of real estate owned by borrowers when assessing credit risk for all kinds of loans. In addition, mortgage lenders' claims on borrowers' real estate assets can be invoked in case of non-payment of other (non-mortgage) loans or overdrafts.

3. Lending and funding

3.1. Primary source of funding

Credit institutions list mortgage loans on their balance sheets. They are mostly funded by variable rate deposits.

3.2. Securitisation of loans

The legal infrastructure for securitisation was enacted in 2004. However, the law in question has hardly been used for the securitisation of mortgage loans.

3.3. Role of public or quasi-public chartered institutions

One of the banks with the largest market shares is state-owned. However, in practice, it operates under the same conditions as any other commercial bank. Formally, the only difference is that the shareholder is the state.

3.4. National or private insurance schemes related to mortgage contracts

It is common practice for the lender to invite the borrower to subscribe to outstanding balance insurance, a kind of life insurance that ensures repayment of the amount still due on the loan during the period for which cover is taken out. If the insured person dies during that time, the insurance company pays this amount directly to the bank. Outstanding balance insurance can also cover two people, but does not cover credit risk. Some insurance policies can be extended to include cover for disability. Lenders often also require borrowers to insure property against fire and other risks.

The insurance cover is sold by the lender on behalf of an insurance company. The insurance company often belongs to the same group as the lender.

3.5. Special regulations/laws regarding funding practices

There is currently no special regulation for housing finance. However, the government took measures in the early 1970s to restrict credit in an attempt to limit house price inflation.

Some banks have subscribed to the "European agreement on a voluntary code of conduct on pre-contractual information for home loans". This agreement was negotiated and adopted by European consumer associations and the European Credit Sector Associations.

3.6. Evolution of lending institutions' risk management practices

The loan-to-value ratio has increased over the last two decades from some 60-80% in the early 1980s to 80-100% at present. This evolution reflects the increase in real estate prices, which makes it difficult for households to save as much as 40% of the value of the dwelling. The loan-to-value ratio exceeds 80% only in exceptional cases justified by the financial situation of the individual household.

The ratio of mortgage payments to household disposable income generally does not exceed 30-40%. The number of individuals in the household is taken into account when assessing ability to repay the loan. The ratio of mortgage payments to household disposable income could exceed the value indicated above for high-income households.

In early 2003, the Eurosystem implemented a quarterly bank lending survey which also provides some insight into changes in credit standards based on a sample of Luxembourg banks. The results from all available survey cycles for Luxembourg can be summarised as follows. First, banks reported a slight easing of credit standards for housing loans in the third quarter of 2004 and of 2005. Second, a net tightening of credit standards was observed in four quarters (2003 Q2, 2003 Q3, 2004 Q1 and 2004 Q4). Third, credit standards were stable in six quarters (2002 Q4, 2003 Q1, 2003 Q4, 2004 Q2, 2005 Q1 and 2005 Q2). Overall, Luxembourg banks seem to have tightened credit standards for housing loans over the period covered by the survey. This tightening was mostly driven by the perception of risk (ie "expectations regarding general economic activity" and "housing market prospects").

4. Regulation

4.1. The nature of borrower protection

A law of 8 December 2000 enacts a regime for helping overly indebted households, allowing them to suspend lenders' actions for six months. This period is used by the "Mediation Commission" to set up a plan for rescheduling the debt. The courts are only involved if lenders do not agree with the proposed plan. The law in question is hardly used in practice.

4.2. Lenders' access to exercise their rights in default

Lenders can have real estate auctioned by a notary public. Five months are usually required for payment to creditors. Lenders' claims to the assets are formally registered. The lenders have a privilege over any other claimants on the financed real estate. The existence of such rights is public information. See also point 1.4 above.

4.3. Operational infrastructure with respect to credit risk assessments, accounting, servicing and administration

There is no specific legislation or regulation covering the mortgage market. However, credit institutions have been subject to capital requirements for mortgage loans since 1993. These capital requirements ensure that credit institutions hold enough funds to cover the credit risk associated with mortgage loans. The treatment of mortgage credit risk has remained unchanged since 1993. It is unclear to what extent these capital requirements have had an impact on the supply of mortgage loans and/or their cost for households. This problem is complicated by a long-standing liability-based system that requires credit institutions to hold enough own funds.

There is no law, regulation or convention specifying a maximum ratio of loans to value and/or of mortgage payments to disposable income. However, mortgage lenders do apply such maximum ratios in assessing credit risk (see point 3.6).

Banking or other professional activity in the financial sector is subject to approval based on conditions laid down in the law on the financial sector. These conditions provide, among other things, that institutions present evidence of an adequate administrative and accounting organisation and of internal control procedures. The authority in charge of prudential supervision (the Commission de Surveillance du secteur financier, CSSF) has issued several circulars to clarify the application of these legal provisions. The CSSF has also published instructions for banks ("Recueil des instructions aux banques") regarding accounting and reporting requirements.

5. International links

5.1. The importance of foreign investors

The institutions providing housing finance are mainly banks incorporated under Luxembourg law. It should be noted that two of the most important participants in the housing finance market are owned by foreign banks.

In addition, the "Bausparkassen" (building societies) are branches of companies incorporated in Germany. These represent only a small share of housing finance in Luxembourg.

There is no information on the volume of loans for housing located in Luxembourg granted by institutions operating abroad. However, it seems reasonable to assume that institutions abroad do not provide a significant share of Luxembourg's housing finance.

5.2. The main activities of foreign financial institutions

The activity of foreign financial institutions in the Luxembourg housing finance market appears to be limited. However, as noted before (see point 5.1) two of the most important participants in the housing finance market are owned by foreign banks…

5.3. Activity of domestic financial institutions in foreign markets

As at 31 December 2004, about 5.7% of outstanding loans were granted to borrowers residing in other euro area countries, while 94.3% were granted to Luxembourg residents. The share of the outstanding loans granted to residents remained broadly stable in 2005 (94,6% as at 31 December 2005).