

**WARNING OF THE EUROPEAN SYSTEMIC RISK BOARD**  
**of 22 September 2016**  
**on medium-term vulnerabilities in the residential real estate sector of Luxembourg**  
**(ESRB/2016/09)**  
(2017/C 31/06)

THE GENERAL BOARD OF THE EUROPEAN SYSTEMIC RISK BOARD,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macroprudential oversight of the financial system and establishing a European Systemic Risk Board <sup>(1)</sup>, and in particular Articles 3 and 16 thereof,

Whereas:

- (1) Past experience in many countries shows that the manifestation of residential real estate vulnerabilities may lead to significant risks to domestic financial stability and serious negative consequences for the real economy, as well as potentially leading to negative spill-overs to other countries.
- (2) The European Systemic Risk Board (ESRB) has recently concluded a systematic and forward-looking Union-wide assessment of vulnerabilities relating to residential real estate. In this context, the ESRB has identified in eight countries certain medium-term vulnerabilities as a source of systemic risk to financial stability, which may have the potential for serious negative consequences for the real economy.
- (3) The ESRB's vulnerability assessment highlights the following for Luxembourg:
  - a. Residential real estate prices in Luxembourg have been increasing steadily for some time. Prices are currently at an unprecedentedly high level, and are increasing both in relation to income and rents. These price developments have been sustained by a structural imbalance between a strong housing demand fuelled, inter alia, by both demographic factors and policy incentives in addition to supply-side limitations on the availability of housing.
  - b. Increasing residential real estate prices could interact with vulnerabilities related to household indebtedness and lead to a further increase in overall indebtedness and in the proportion of vulnerable households. Mortgage credit has been increasing rapidly in recent years and the level of mortgage debt is high in relation to the disposable income of Luxembourg households. Furthermore, households have some exposure to interest rate risk since mortgage loans tend to have variable interest rates. On average, loan-to-value and debt-service-to-income ratios in Luxembourg are moderate and may act as a mitigating factor against losses in the financial system should vulnerabilities crystallise. However, the distribution of these ratios both for new and existing mortgages suggest that there is a noticeable share of mortgagors with high debt and high debt servicing costs relative to income.
  - c. The vulnerabilities in the household sector coupled with the already elevated and robustly increasing real estate prices, expose the real economy in Luxembourg to financial stability risks. In the event of an economic or financial shock — such as an increase in unemployment and/or a fall in income growth or residential real estate prices — highly indebted households may find it particularly difficult to service their debts and the number of mortgage defaults may increase leading to direct credit losses to banks, especially in the event of a fall in residential real estate prices. Moreover, if an adverse scenario for the economy does materialise, the associated negative household income and wealth effects may reinforce the initial shock, further enhancing the negative direct and indirect effects on financial stability (e.g. if households need to reduce consumption in order to service their mortgage loans). This problem could become more pronounced if the trend of increasing household debt in Luxembourg continues. It should be noted that Luxembourgish households also have high levels of financial assets, though decreasing in relation to debt, which could act as a mitigant in case of a shock if households are willing and able to draw on these sources of wealth.

<sup>(1)</sup> OJ L 331, 15.12.2010, p. 1.

- d. The ESRB notes the measures implemented by the authorities in Luxembourg in relation to residential real estate. To date the measures implemented have been focused on increasing the resilience of the banking sector, by increasing the risk weights of mortgages with high loan-to-value ratios, and by applying capital buffers both to the whole of the banking sector and to systemically important institutions. On average, banks in Luxembourg are well-capitalised and have relatively low exposures to residential real estate. Given these policy measures, the direct risks to the banking system related to residential real estate vulnerabilities seem limited at present.
- e. Besides implementing microprudential measures to require that banks have appropriate internal governance and policies with respect to the mortgage market, no macroprudential measures have been implemented to reduce vulnerabilities linked to the potential negative interaction between household indebtedness and residential real estate price dynamics. For this reason the policies implemented by the Luxembourgish authorities may not be appropriate to fully address the identified vulnerabilities,

HAS ADOPTED THIS WARNING:

The ESRB has identified medium-term vulnerabilities in the residential real estate sector of Luxembourg as a source of systemic risk to financial stability, which may have the potential for serious negative consequences for the real economy. From a macroprudential perspective, the ESRB considers the main vulnerabilities to be the combination of high residential real estate prices and increasing household indebtedness.

Done at Frankfurt am Main, 22 September 2016.

Francesco MAZZAFERRO

*Head of the ESRB Secretariat*

*On behalf of the General Board of the ESRB*

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