EUROPEAN CENTRAL BANK

EUROSYSTEM

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OPINION OF THE EUROPEAN CENTRAL BANK

of 27 September 2019

on additional macroprudential tools for residential mortgages

(CON/2019/34)

Introduction and legal basis

On 29 July 2019, the European Central Bank (ECB) received a request from the Luxembourg Ministry of Finance for an opinion on draft governmental amendments to the draft law on macroprudential measures on residential mortgage loans in Luxembourg and amending the Law on banking and the Law establishing the Luxembourg Systemic Risk Committee[1] (hereinafter the 'draft amendments').

The ECB's competence to deliver an opinion is based on Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union and the sixth indent of Article 2(1) of Council Decision 98/415/EC[2], as the draft amendments relate to rules applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

1. Purpose of the draft amendments

1.1 The draft amendments are introduced to the draft law on macroprudential measures on residential mortgage loans in Luxembourg[3] (hereinafter the 'draft law'). The draft law proposed new macroprudential measures to be taken by the *Commission de Surveillance du Secteur Financier* (CSSF, Financial Sector Supervisory Commission) regarding conditions for the granting of loans secured by mortgages on residential property located in Luxembourg by credit institutions, insurance companies and professionals performing credit operations. These measures include: the loan-to-value (LTV) ratio, the loan-to-income (LTI) ratio, the debt-to-income (DTI) ratio, the debt-service-to-income (DSTI) ratio and maturity limits (hereinafter collectively referred to as 'borrower-based measures').

1.2 According to the explanatory memorandum, the purpose of the draft amendments is to follow up on the formal opposition to the draft law as expressed by the Luxembourg *Conseil d'État* (State

1 Amendements gouvernementaux au projet de loi n°7218 relative à des mesures macroprudentielles portant sur les crédits immobiliers résidentiels et portant modification de: - la loi modifiée du 5 avril 1993 relative au secteur financier; - la loi du ler avril 2015 portant création d'un comité du risque systémique et modifiant la loi modifiée du 23 décembre 1998 relative au statut monétaire et à la Banque centrale du Luxembourg.

2 Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions (OJ L 189, 3.7.1998, p. 42).

3 Projet de loi n°7218 relative à des mesures macroprudentielles portant sur les crédits immobiliers résidentiels et portant modification de: - la loi modifiée du 5 avril 1993 relative au secteur financier; - la loi du ler avril 2015 portant création d'un comité du risque systémique et modifiant la loi modifiée du 23 décembre 1998 relative au statut monétaire et à la Banque centrale du Luxembourg.

Council) in the context of the national legislative procedure[4]. In its opinion, the *Conseil d'État* requests a precise definition of the normative framework within which the CSSF may act when deciding on the application of borrower-based measures for loans secured by mortgages on residential property under the draft law. In response to this, the draft amendments more precisely define the normative framework within which the CSSF may act in this respect.

1.3 First, the draft amendments define a cumulative list of conditions that must be met for the CSSF to adopt borrower-based measures[5]. These conditions are: (1) the activation of the measures can help to counteract the malfunctioning of the national financial system or reduce the accumulation of risks to national financial stability arising from developments in the real estate sector in Luxembourg, and (2) no other measures that may be taken under the Law of 5 April 1993 on the financial sector, Regulation (EU) No 575/2013 of the European Parliament and of the Council[6] or their implementing acts, taken independently or together, would allow these risks to be adequately mitigated. In order to strengthen this mechanism, an explicit duty is imposed on the *Comité du Risque Systémique* (CdRS, the National Systemic Risk Committee) to assess whether, in the event of a sustained and persistent increase in house prices and in the volume of loans secured by mortgages on residential property coupled with a significant deterioration of the ratios of the borrower-based measures, such developments indicate a vulnerability in the national financial system or pose a risk to national financial stability.

1.4 Second, the draft amendments restrict the scope of the borrower-based measures that may be adopted pursuant to the draft law by expressly excluding credit contracts in force at the time of the decision by the CSSF.

1.5 Third, the draft amendments introduce corridors for the maximum limits that the CSSF can apply when adopting borrower-based measures[7]. These corridors are: (1) 75 to 100% for the maximum limit for the ratio between the total credit obligations of a borrower and the total market value of a given property (LTV ratio); (2) 400 to 1200% for the maximum limit for the ratio of the total amount of a borrower's repayment obligations resulting from a loan secured by a mortgage on residential property and the borrower's total available annual income (LTI ratio); (3) 400 to 1200% for the maximum limit for the ratio between the borrower's total indebtedness and the borrower's total available annual income (DTI ratio); (4) 35 to 75% for the maximum limit for the ratio between the total annual mortgage charges and the borrower's total available annual income (DSTI ratio); and (5) 20 to 35 years for the maximum limit for the initial maturity of the loan (maturity limits).

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4 The *Conseil d'Etat* must issue its opinion on draft laws, and must, in particular verify the draft laws' conformity with the Constitution of Luxembourg, international treaties, Union legal acts and general principles of law on the basis of Article 1 of the Law of 16 June 2017 on the organisation of the *Conseil d'État* (Loi du 16 juin 2017 sur l'organisation du Conseil d'État).

5 See the draft amendment to draft Article 59-14bis(1) of the Law of 5 April 1993 on the financial sector (La loi modifiée du 5 avril 1993 relative au secteur financier).

6 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

7 See amendment to draft Article 59-14bis(2) of the Law of 5 April 1993 on the financial sector.

1.6 Finally, the draft amendments remove from the draft law the possibility that the CSSF may recognise conditions set down by the national authorities of other Member States for granting loans for property located in those Member States and apply them to the entities under its supervision[8].

2. General observations

2.1 As emphasised in previous opinions[9], from a financial stability perspective, the ECB welcomes the implementation of a legislative framework for borrower-based measures in all euro area Member States. The ECB notes its recommendation to add borrower-based instruments to the European macroprudential toolkit, such as limits on LTV, LTI or DSTI ratios, which are known to be more effective in addressing risks[10]. The ECB also welcomes the core objective of the envisaged legislative framework on borrower-based measures under the draft law, namely to equip the Luxembourg authorities with macroprudential tools to be used in the event of threats to the stability of the national financial system due to developments in the Luxembourg real estate sector. This objective is also in line with the principles set out in the ESRB's Recommendation on intermediate objectives and instruments of macro-prudential policy, in particular with regard to the objective to mitigate and prevent excessive credit growth and leverage[11].

2.2 The ECB understands that the sole objective of the draft amendments is to ensure that the draft law complies with national constitutional law, following the formal opposition of the *Conseil d'État*, and therefore aims to circumscribe the powers of the CSSF in relation to the adoption of macroprudential measures. The *Conseil d'État* has noted that these powers touch upon a field that is normally reserved to the law and not to the regulatory power by the Constitution of Luxembourg, namely the freedom to trade protected by Article 11(6) of the Constitution[12]. The ECB understands that the conditions and limits imposed on the powers of the CSSF to adopt macroprudential measures are required in order for these measures to be legally sound within the national constitutional legal framework.

2.3 The ECB has already delivered its opinion on the draft law[13]. The ECB notes that the draft amendments do not amend the aspects on which the ECB has previously opined. Against this

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8 See paragraph 1.4 of Opinion CON/2018/9. All ECB opinions are published on the ECB website at www.ecb.europa.eu.

9 See paragraph 2.3 of Opinion CON/2017/11; paragraph 2.4 of Opinion CON/2017/21 and paragraph 3.2 of Opinion CON/2018/9.

10 See paragraph 1.2 of Opinion CON/2017/46; ECB contribution to the European Commission's consultation on the review of the EU macroprudential policy framework, page 5, available at https://www.ecb.europa.eu/pub/pdf/other/revieweumacroprudentialpolicyframework201612.en.pdf.

.11 See paragraph 2.2 of Opinion CON/2017/11 and paragraph 2.3 of Opinion CON/2017/21; Recommendation of the European Systemic Risk Board of 4 April 2013 on intermediate objectives and instruments of macro-prudential policy (ESRB/2013/1) (OJ C 170, 15.6.2013, p. 1); 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) (OJ C 31, 31.1.2017, p. 31). See also Recommendation of the European Systemic Risk Board of 27 June 2019 on medium-term vulnerabilities in the residential real estate sector in Luxembourg (ESRB/2019/6). Not yet published in the *Official Journal of the European Union.*

12 See the opinion of the Conseil d'État (Avis du Conseil d'Etat, 20.3.2018, Projet de loi n°7218 relative à des mesures macroprudentielles portant sur les crédits immobiliers résidentiels et portant modification de: - la loi modifiée du 5 avril 1993 relative au secteur financier; - la loi du ler avril 2015 portant création d'un comité du risque systémique et modifiant la loi modifiée du 23 décembre 1998 relative au statut monétaire et à la Banque centrale du Luxembourg), p.2.

13 See Opinion CON/2018/9.

background, the ECB reiterates the observations made in its previous opinion[14]. The ECB emphasises, in particular, that the Banque centrale du Luxembourg (BCL) should play a leading role in macroprudential oversight, given BCL's expertise and existing responsibilities in the area of financial stability[15].

3. Specific observations

3.1 Corridors for the maximum limits for the ratios of the borrower-based measures

In general, the ECB stresses that the relevant authorities should have the capability to act in a flexible and proportionate way when setting and calibrating macroprudential measures, in order to address effectively and efficiently potential risks to financial stability[16], while acting within the pre-established legal framework. The ECB understands that the draft amendments introduce corridors for the maximum limits for the ratios of the borrower-based measures in order to comply with national constitutional requirements. Available information on borrower-based measures adopted by other Member States[17] suggests that the lower limits for the foreseen corridors for the LTV, LTI, DTI and DSTI ratios under the draft law are close to the ratios that are applied in most of these Member States. In that context, a reduction of the lower limits of the corridors in respect for the LTV, DTI, LTI and DSTI ratios, to the extent possible within the national constitutional framework, would ensure effective policy action, taking into account changing macro-financial conditions. Such a reduction of the lower limits would also allow for the potential application of stricter limits, for instance for buy-to-let purposes, for non-first time buyers, as well as under stress scenarios. Moreover, the upper limits for the income based ratios (LTI, DTI and DSTI ratios) under the draft law may be considered as too high[18] given that such corridors might implicitly be interpreted as normative guidance for acceptable or prudent lending standards. Finally, the ECB suggests a regular review of the corridors, in order to allow the Luxembourg authorities to take into account policy experience and the implications of changes in macroeconomic and financial conditions[19].

3.2 Conditions for the activation of the borrower-based measures

It is important that the decisions on the activation of borrower-based measures are taken in a prudent and preemptive manner, in order to mitigate the intensification of risks at an early stage and prior to the actual deterioration of the respective lending ratios. In this regard, the ECB understands that the draft amendments introduce certain conditions related to financial stability that must be met for the activation of borrower-based measures in order to comply with national constitutional requirements[20]. The activation of the borrower-based measures is based on a two-

14 See paragraphs 2 and 3 of Opinion CON/2018/9.

15 See paragraph 2 of Opinion CON/2018/9. See also paragraph 5.2 of Opinion CON/2014/46 and paragraph 2.3 of Opinion CON/2018/34.

16 See paragraph 2.3 of Opinion CON/2017/11.

17 Due to the lack of harmonisation of borrower-based measures and the related statistical data, there is limited information available to compare these measures across Member States. See ESRB, Overview of national measures of macroprudential interest, available on the ESRB's website at www.esrb.europa.eu.

18 Compared to applied income-based measures in other euro area countries.

19 See paragraph 2.3 of Opinion CON/2017/11; paragraph 2.4 of Opinion CON/2017/21; paragraph 2 of Opinion CON/2016/8.

20 According to the explanatory memorandum, the conditions set forth for the authorities of other Member States, in particular for the German authorities, were taken into account in this context.

step mechanism. First, the CSSF should act following a recommendation issued by the CdRS where it has found a malfunctioning of the national financial system or the existence (or emergence) of a risk to national financial stability stemming from developments in the real estate sector. The CdRS can issue recommendations on corrective measures to address identified risks to financial stability, including recommendations concerning macroprudential tools used to achieve the objectives of macroprudential policy and intermediary objectives, by virtue of the Law of 1 April 2015[21]. Second, this mechanism is reinforced by the clarification that certain predetermined events trigger the compulsory assessment of the situation by the CdRS (i.e. a sustained and persistent increase in house prices and in the volume of loans secured by mortgages on residential property, coupled with a significant deterioration of the ratios when granting loans). The ECB understands that this two-step mechanism would generally allow the Luxembourg authorities to activate borrower-based measures with a forward-looking perspective.

3.3 Sequencing of the activation mechanism of the borrower-based measures

The ECB understands that the proposed sequencing of the activation mechanism of the borrower-based measures (the so-called 'pecking order') is justified by the need to comply with national constitutional requirements. The ECB reiterates its stance, with regard to Union legislation, that the pecking order should be removed as it constitutes a deterrent regarding the selection of instruments and results in a bias towards inaction[22]. Macroprudential instruments should be chosen on the basis of their effectiveness and appropriateness, and not of mandatory sequencing. Against this background, and taking the constitutional constraints in Luxembourg into account, the ECB encourages the Luxembourg authorities to regularly review the application of the pecking order in order to ensure that it does not result in an inappropriate bias towards inaction in the activation of borrower-based measures.

3.4 Reciprocity of borrower-based measures applied by authorities of other Member States

The ECB reiterates the importance of the cross-border recognition of macroprudential policies to foster the effectiveness of national macroprudential policies, as well as to pre-empt leakages in the financial system and ensure a level playing field for domestic and foreign banks. The European Systemic Risk Board also encourages the reciprocation of macroprudential tools[23]. The ECB supports this approach[24]. It is crucial to extend reciprocity to the extent possible under Luxembourg law, unless the relevant authority provides a reasoned justification not to apply the measure to other exposure-based measures, including activity-based measures that address risks to domestic

21 See Article 2 of the Law of 1 April 2015 establishing the National Systemic Risk Committee (La loi du ler avril 2015 portant création d'un comité du risque systémique et modifiant la loi modifiée du 23 décembre 1998 relative au statut monétaire et à la Banque centrale du Luxembourg).

22 See paragraph 1.2 of Opinion CON/2017/46.

23 Recommendation of the European Systemic Risk Board of 15 December 2015 on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures (ESRB/2015/2) (OJ C 97, 12.3.2016, p. 9), the consolidated text can be found on the Publication Office's website at www.eur-lex.europa.eu or the European Systemic Risk Board's website at www.esrb.europa.eu. The concept of 'reciprocity' is defined in this Recommendation as 'an arrangement, whereby the relevant authority in one jurisdiction applies the same, or equivalent, macroprudential measure, as is set by the activating relevant authority in another jurisdiction, to any financial institutions under its jurisdiction, when they are exposed to the same risk in the latter jurisdiction'.

24 See the ECB's contribution to the European Commission's consultation on the review of the EU macroprudential framework, page 16 to 17, available on the European Commission's website at www.ec.europa.eu. See also paragraph 1.2 of Opinion CON/2017/46.

exposures (such as LTV, LTI, and DSTI ratios) and sectoral capital requirements . Some Member States have enshrined the reciprocation of borrower-based measures in their national law[25]. Against this background, the ECB recommends establishing, within the limits of the national legal framework, the possibility for the CSSF to recognise borrower-based measures taken by the national authorities of other Member States.

This opinion will be published on the ECB's website.

Done at Frankfurt am Main, 27 September 2019.

[signed]

The President of the ECB

Mario DRAGHI

25 See paragraph 1.3 of Opinion CON/2017/21.