Luxembourg, 17 December 2018

To all lenders in residential real estate

CIRCULAR CSSF 18/703 as amended by Circular CSSF 20/737

Re: Introduction of a semi-annual reporting of borrower related residential real estate indicators

Ladies and Gentlemen,

The objective of this circular is to introduce a macroprudential risk monitoring framework for the residential real estate sector in Luxembourg which is based on a recommendation by the European Systemic Risk Board (ESRB/2016/14 Recommendation of the European Systemic Risk Board of 31 October 2016 on closing real estate data gaps – hereinafter "the ESRB recommendation"). The reporting aims at collecting indicators on lending standards in the residential real estate (RRE) market[1]. The circular introduces definitions of these indicators that are collected via a dedicated template available on the CSSF website.

[1] Please note that the recommendation ESRB 2016/14 also covers data gaps regarding commercial real estate (CRE) lending. CRE data is not covered by this circular.

1. Scope

The scope of the data collection refers to loans taken for the purpose of purchasing residential real estate in Luxembourg, and that are secured by real estate collateral located in Luxembourg[2]. Residential real estate includes existing dwellings, dwellings to be built (as per contract) or land that can be used for the construction of residential real estate dwellings.

Loans that are granted to a legal entity should not be included in the reporting. This implies that loans granted indirectly to natural persons for investment purposes through 'Société civile immobilières' or SOPARFIs are excluded from the reporting. It should be noted that real estate credit provided to such entities falls under the scope of commercial real estate (CRE), and related indicators are part of a dedicated reporting, and in the AnaCredit reporting.

2. Process

This circular specifies the residential real estate data that will be collected through a dedicated RRE data template. The data will be collected by the CSSF semi-annually in the months of April and October each year. The reference date for the data collection will be the 31st of December and the 30th of June respectively. The template specifying the data to be reported can be found on the CSSF website. Lenders that are active in the residential real estate sector are expected to be able to produce the requested data at a semi-annual frequency. This expectation pre-supposes the ability of lenders to store and process the relevant information in their information systems so that adequate reports can be extracted regularly.

[2] The scope includes loans for owner-occupied or buy-to-let housing. Any loan contracted via a real estate savings' plan (BSH, BHW, etc.) is part of the scope. Loans granted for the renovation of a property and that are secured by a real estate property are also included in the scope. Loans for renovation works that are not secured by a real estate property should not be included.

3. Definitions of the indicators for borrower based measures

LTV- Loan to Value

At origination

$$\mathbf{LTV - O = \frac{L}{V\ at\ origination}}$$

Current

$$\mathbf{LTV - C = \frac{L}{V\ current}}$$

LSTI- Loan service to income

At origination

$$\mathbf{LSTI = \frac{LS}{I}}$$

DSTI- Debt service to income

At origination

$$\mathbf{DSTI = \frac{DS}{I}}$$

LTI- Loan to income

At origination

$$\mathbf{LTI = \frac{L}{I}}$$

DTI- Debt to income

At origination

$$\mathbf{DTI = \frac{D}{I}}$$

The LTV indicator can be ‘at origination’ or ‘current’. These concepts, taken from the ESRB recommendation correspond to, respectively, new credit exposures (flows) and outstanding credit exposures (stock). Therefore, LTV ‘at origination’ is to be computed for new loans, i.e. loans granted in the reference period of the reporting. Loans that have been granted before but were modified loans should not be included with the new loans.[3] LTV ‘Current’ is to be computed for the complete stock of outstanding loans. Any loan modification such as a change in the interest rate type should be reported as

[3] Loans being restructured due to considerations of unlikeliness to pays shall be considered as modified existing loans and thus be excluded from the new credit exposures (flows) but included in the outstanding credit exposures (stock).

an outstanding loan, except if the loan took over an existing loan from another lender. In such a case the loan can be considered as a new exposure.

4. Guidance on variables contained in the indicators

L - Loan

The variable **L** should contain all loans and loan tranches granted to the borrower, for the purpose of purchasing a residential real estate property, which can be existing or to be built. This loan must be secured by one or several real estate properties.

The **L** should be aggregated by borrower and by financed property. This implies that:

(i) If the borrower is a couple (i.e. if the loan contract runs in two names) it is considered as a single borrower.

(ii) If two or more properties are used as collateral, but the loan relates to a single property, one single indicator should be calculated.

(iii) In case a bridge loan is granted along with another loan to finance a new property, the loans should be separated according to the property they finance.

No reduction of **L** by credit risk mitigants is allowed in the context of the reporting. **L** is not to be reduced by the amount of, for example, state and/or personal guarantees the debtor receives, cash reserves, or similar.

L is measured by the granted amount of each loan or tranche. The granted amount is the loan amount offered by the lender to the borrower as per contractual provisions and signed by the stakeholders concerned. Borrowers may have received one or more loan offers from different lenders but a contract becomes binding only upon signature by the borrower. The amount referred to in the signed contract should be reported by the lender as the granted loan amount.

V – Value

The variable **V** should be computed on the basis of the value of the property (or properties) given as collateral. If several properties are securing a given loan, the values of these properties can be summed. It is not possible to use the mortgage value registered in a mortgage collateral register ("inscription hypothécaire") nor the mortgage promise value ("mandat hypothécaire") to obtain the value.

V should be adjusted by the total amount of the outstanding RRE loan, disbursed or not, that is secured through 'prior' liens on the property. In cases where one or several higher ranked mortgages exist on the property given as collateral, V is lowered by the mortgage value or the outstanding amount of a loan secured in first lien by this same property.

V should not be adjusted for the presence of other credit risk mitigants. Other credit risk mitigants can generally be understood as additional pledges to secure the loan but which are not RRE collateral (such as a financial collateral pledge).

At origination

The **V at origination** should be obtained at the loan origination and be measured as the lower of:

(i) the transaction value of the immovable property in case the property given as collateral is subject to a transaction, or;

(ii) the value as assessed by an independent external or internal appraiser at loan origination.

If only one value is available, this value may be used.

In the case of renovation associated with the purchase of an existing property, the **V at origination** should be augmented by a fraction of the renovation costs with a range of 0% to 80% of their value as stated in the offer documents ("devis"). The lender should request this information from the borrower and document the provided evidence that allow for an estimation of the renovation costs. The lender should define internal policies to guide decisions on the fraction of renovation costs that will augment the value and follow them systematically.

In the case of land purchase ("terrain") with the purpose to build, the value of the land is augmented by an estimation of the construction costs based on the offer document/construction contract from the constructor. If, for some reason, the buyer/borrower cannot provide evidence on the estimation of future construction costs, the property value should be the price of the land. In the case of purchase of a property under development ("vente en l'état futur d'achèvement", "VEFA"), the property value is the price registered in the purchase contract ("contrat de vente"). The VAT rate for VEFA is 17%.

V at origination should not be computed as the 'long-term value' because the value at origination aims at capturing credit standards at origination.

Current

The variable **V current** should be monitored and reviewed in accordance with Article 208(3) CRR. Therefore it should be assessed by an independent external or internal appraiser. The assessment can be made using either a valuation model or a RRE value index.

(i) Using a valuation model: Such an approach requires lenders to collect and use information on each property on a regular basis in order to update their valuations when needed as well as follow the developments of economic fundamentals.

(ii) Using a RRE value index: Such an index should be sufficiently granular with respect to geographical location (i.e. municipality) and type (i.e. new, old, apartment, house) of property; if such real estate value index is not available, a RRE value index sufficiently granular with respect to geographical location and type of property can be used after application of a suitably chosen mark-down to account for the depreciation of the property.

Whatever the choice, the independence of the appraiser should be guaranteed. Independence in this context is to be understood in the spirit of Article 208(3)(b) CRR, i.e. independence from the credit granting decision process. For example, if the current value calculation is performed in-house, it should not be performed by the commercial agents but by a dedicated unit such as the Risk Management unit. Further elaborating on the independence requirement, the following cases can be differentiated:

(i) Valuation developed and applied in house: Employees of the lender can develop and perform such a valuation and the valuation will be considered independent as long as these employees are not commercial agents.

(ii) Valuation developed by a third party and applied in house: In general, it can be assumed that a third party provider can be considered independent from the credit decision process. The independence criterion is satisfied when a third party provider develops the valuation method and a dedicated in house function other than the commercial function applies this method and performs the valuation.

(iii) Valuation developed and applied by a third party: In general, it can be assumed that in cases the lender has overall outsourced the valuation to a third party, the independence criterion is satisfied. Finally, when a third party is involved, the requirements of Circular CSSF 12/552 (section 7.4) on outsourcing apply (i.e. final responsibility always lies with the lender).

The computation of **V current** should be documented by the lender in a clear and transparent manner. Its valuation methodology is reported in the lender's internal procedure documents and the lender is in a position to report details of its approach to the CSSF.

I – Income

The variable **I** should be obtained as the sum of all sources of recurring income of the borrower, minus taxes (net of tax rebates) and premiums, such as for health care, social security or medical insurance. If a couple borrows to buy a house, the sum of the couple's income should be considered. No other income (parents, etc.) should be considered. Lenders should document all sources of income. The income should be computed on an annual basis.

Therefore, in general, **I** should be computed as follows:

Disposable income = regular employee income (excluding bonuses, including contractually agreed payments like e.g. 13th month salary) + self-employment income-taxes- social security contributions

In cases where the borrower's income contains a significant share of investment income, it is possible to deviate from this formula. The lender should apply appropriate haircuts to account for the irregularity of certain types of income.

Lenders calculating income in accordance with EBA guidelines on creditworthiness assessment (EBA/GL/2015/11) points 4.1-4.4 and with Art. L. 226-12 of the Luxembourg law of 23 December 2016 transposing Directive 2014/17/EU of the European Parliament and the Council of 4 February 2014 ("The Mortgage Credit Directive"), can follow this practice for the calculation of the variable **I**.

D – Debt

The variable **D** should be obtained as the total debt amount of the borrower at the moment of origination. **D** should include all the loans contracted by the borrower, including loans contracted in other credit institutions and for other purposes than the purchase of real estate. For instance, consumer loans should be attached to **D**, even if they are not secured by real estate collateral. Lenders are required to ask the borrower for any existing debt contracted and to document it.

DS and LS – Debt service and loan service

The variable **LS** contains the annual amount of loan servicing costs of the RRE loan at the moment of origination. **LS** should include the borrower's effective annual payments made to service the loan. Therefore, it includes both the interest and the principal repayment of all loan tranches associated with one real estate property. Loan servicing costs should be calculated by borrower and by financed property. For bridge loans only interest payments are included in **LS**.

The variable **DS** should be obtained as the annual amount of debt servicing costs of the total debt of the borrower at the moment of origination. **DS** should include both the interest and the principal repayment of all types of loans of the borrower, including loans granted by the real estate lender and others, whether secured by real estate or not.

In specific cases, the following considerations apply for the calculation of **DS** and **LS**:

(i) Non-amortizing loans where only interests are paid during the lifetime of the loan, while the principal is paid at maturity should be treated exactly as such. At origination the DS/LS variables would therefore contain interest payments only.

(ii) Where part of the debt reimbursement is deferred for a certain period at the beginning of the loan contract (e.g. a “moratoire”), the total servicing cost of the loan is the amount that will fall due once the loan repayment starts.

(iii) Bullet loans, where no interest nor principal payments are paid during the lifetime of the loan should not give rise to the calculation of a LS nor DS.

(iv) If contracted for the purpose of a real estate purchase or renovation, saving plans payments (i.e. BHW, BSH, etc.) should be included in the LS or DS. A savings plan (contrat d'épargne logement) is contracted for the purchase, the construction or renovation of real estate properties and implies the regular payment of capital into a fund or to the lender. Moreover, these payments contribute to the repayment of the loan and should be considered as loan service costs. LS (or DS) can thus be computed by considering the total amount of annual contributions to the saving plan.

Maturity at origination

Maturity at origination means the term of the RRE loan contract expressed in years at the moment of loan origination. The maturity to be reported should be one referred to in the signed contract by the concerned stakeholders.

Bridge loans

Bridge loans are non-amortizing real estate loans that are used to facilitate a transaction. They can be used to finance the sale of an existing property for a limited period of time or to bridge the gap between the moment of granting a mortgage and the receipt of some amount of cash by the borrower that would be paid into the real estate purchase at a later date. In general, bridge loans should not exceed a maturity of 2 years and be non-renewable.

Amount and number

For each of the indicators illustrated above, lenders are expected to report the amount of exposures they have with a given indicator. When a number is required, it refers to the number of contracts with a given indicator.

Standards for transmission

The filled-in templates have to be submitted to the CSSF at the defined reporting date through one of the currently accepted transmission channels E-file or SOFiE. Reports referring to end-December data are to be submitted by the 15th of April each year (or the preceding business day if this date falls on a holiday).

Reports referring to end-June data are to be submitted by 15th of October each year (or the preceding business day if this date falls on a holiday).

The template can be found on the CSSF website. Reporting institutions should always be sure to submit the latest version of the template. In case of changes to the template the CSSF will duly inform reporting institutions.

Templates should be named as follows:

ESPREP-ENNNN-YYYY-MM-RES

Where

- ESP is the reporting type standing for special enquiries
- REP is the direction standing for Report
- E is the entity type, e.g. B for Banks
- NNNN is the identification number of the bank, i.e. 0001...9999
- YYYY is the cut-off year of the data (reporting reference period)
- MM is the cut-off month of the data (reporting reference period)
- RES is the table reference.

For further specification on the CSSF's naming conventions, please refer to information published on the CSSF website.

Contact

For any questions regarding this circular, please contact the macroprudential policy division of the CSSF's SSM coordination department (email: macropru@cssf.lu).

This circular enters into force with immediate effect.

Luxembourg, 17 December 2018

Yours faithfully.

COMMISSION DE SURVEILLANCE DU SECTEUR FINANCIER

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