'Epargne-Logement' in France

by Claude Taffin

Contractual savings for housing, or "épargne-logement" (EL), has become, in about 25 years of existence, a major instrument for financing housing investment in France. Epargne-logement loans directly finance private investment and the remaining funds are used to finance other types of loans.

The system has successfully survived the high inflation years (1980–1982) during which its stability was jeopardized by strong demand for new loans. Now, with low inflation and low interest rates, deposits are growing, providing banks with low-cost funds.

This paper describes the main features of épargne-logement which have been changed very little since its creation, evaluates the economic importance of EL, the financial balance of the system, and in the last part analyzes its influence on the main actors, households and lenders.

DESCRIPTION OF THE SYSTEM

Historical Background

EL was introduced in France in 1965. It is derived from deferred credit, which was created in the United Kingdom in 1781. Deferred credit gave birth to several systems in the western world: building societies in the United Kingdom, mutual savings banks and savings and loan associations in the United States, and bausparkassen in Germany.

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Deferred credit is based upon the principle of mutualization: the new participants entering the system bring funds for lending to the others.

Crédit différé (deferred credit) was officially introduced in France in 1952. Needs for new construction were considerable and financial markets were not developed: long-term mortgage credit was not available until 1966, when the mortgage market was created.

Concurrently, the state tried to encourage savings devoted to housing investment; "épargne-construction" (building savings) was created in 1953. It aimed at protecting savings against inflation. The deposits (in savings banks only) received only a 1% interest rate but, at the end of the contract, provided that the housing project was really completed, the value of the deposit was actualized according to an index matching the building costs.

In 1959, "épargne-crédit" (savings and loans) replaced épargne-construction. In the new system the saver may obtain a loan at a low rate. The minimim saving period is 18 months. There is a double link between the savings and the loan:

- The amounts of interest are equal.
- The interest rate on the loans is equal to the interest rate paid on the savings (2%); a loan servicing fee (0.8% of the amount borrowed) is added. Savings banks have a monopoly of the system.

Epargne-crédit was not very successful. It was replaced by "épargne- logement" in two stages in 1965 and 1969. Epargne-logement is based on the same principle, but there are two major differences:

- It is more attractive for savers and for borrowers.
- Its distribution is standardized and the system is open to all commercial banks. It is no longer a monopoly of savings banks.

The system has two branches: accounts (CEL) created in 1965, and plans (PEL) launched in 1969.

Basic Principles

Only a natural person is entitled to open a CEL or a PEL (and only one of each by one person). They both consist of a contract between the bank and the person by which the person is committed to making deposits and the bank to providing a loan at a given interest rate and of a given amount at the end of the saving period.

The minimum period is 18 months for CEL (with no maximum) and four years for PEL (with a maximum of 10 years).[1] The deposits on a PEL may not be withdrawn before the end of this period; otherwise, the PEL is closed and the amount of the state premium

Table 1. Main Characteristics of Plans D'Epargne-Logement (PEL) and Comptes D'Epargne-Logement (CEL)

	Deposits						*Loans*	
	Minimum Initial Deposit	*Other Payment*	*Maximum Global Deposit*	*Bank Rate*	*State Premium Rate*	*State Maximum Premium*	*Maximum Amount*	*Interest Rate*
PEL	1,500 F	3,600 F	400,000 F	2.86%	1.21%	10,000 F	600,000 F	4.60%
CEL	2,000 F	500 F	100,000 F	2.00%	1.00%	7,500 F	150,000 F	3.50%

Savings rate is higher when there is no state premium (above maximum or after maximum duration of 10 years: 2.90% instead of 2.86%. The loan interest rate of 4.6% is obtained by adding 1.7% to 2.90%.

is reduced. There is no prohibition in the case of a CEL.

There is a maximum amount of deposits (not including interest) and a minimum amount for the initial and the following deposits (see Table 1).

At the end of the contract, the saver may apply for a loan, and the lender may neither refuse nor delay it, even in case of excessive demand. This loan must be used to finance one of the following:

- The construction or purchase of a new housing unit, either primary or second home, for personal use or for renting.
- The purchase of an existing housing unit, in which case, second homes are excluded.
- Repair, improvement or energy saving work in any kind of housing unit.
- The purchase of SCPI (French version of real estate investment trusts).

EL loans may not finance the purchase of land if it is not associated with a building operation.

The basic principle of the system lies in the link between the amount of interest earned on the savings and interest to be paid on the loan. These amounts are not equal, as they were in the previous system. An "interest multiplier" is introduced, equal to 1.5 in the case of CEL and 2.5 in the case of PEL. That multiplier has a leverage effect on the amount of credit available.

The balance of the system would be broken if a majority of savers became borrowers. In order to have a sufficient proportion of savers who do not use their "loan right," (who are called the "good brothers"), it is necessary to keep the interest rate paid to the savers attractive. To achieve this goal, the state intervenes in two ways:

- A state interest subsidy, called "interest premium," is added to the interest paid by the bank.
- Full interest (the part paid by the bank and the state premium) is tax free.[2]

Moreover, the savers who do not need to get a loan for themselves may pass their loan right to a member of their family. Of course, it is necessary that the person concerned have his or her own PEL or CEL.

There is another link between the savings and the loan: the interest rate of the loan is equal to the interest rate of the savings paid by the bank plus a spread designed to cover the loan servicing fee of the bank. The spread was first 1.5%; it was increased to 1.7% for PEL only after 1980.

The loan must be immediately available to the saver as soon as the saving phase is over.

Differences Between Plans (PEL) and Accounts (CEL)

CEL were first created in 1965. They did not succeed very well due to the shortage of funds for principal mortgage loans to go with the EL loans, this in spite of the creation of the mortgage bond market nine months later.

For that reason, PEL was introduced at the end of 1969. The PEL contract differs in several ways from the CEL contract.

- Its loan multiplier is larger (2.5 vs 1.5).
- Its minimum savings period is longer (originally four years vs 18 months).
- Its maximum deposit is larger (+50% in 1970, four times larger now).
- The maximum state premium is larger (+50% in 1970, +33% now).

In 1970 the loan maximum amounts were similar (100,000 Fr.); now the PEL maximum loan is four times larger than that of CEL.

CEL provides better liquidity to savers than PEL: periodic deposits are compulsory on a PEL, with a minimum amount (3,600 Fr. per year) and a fixed periodicity (every month, quarter or half-year) while, on a CEL, not only can payments be made at any time, but also withdrawals are permitted, provided that a minimum deposit of 2,000 Fr. be left on the account.

A major difference between PEL and CEL concerns the availability of the state premium. With a PEL, the state premium is given to all savers who reach the end of the contract, should they borrow or not.

With a CEL, the closing of the account does not imply eligibility for the premium; the premium is paid to borrowers only, which means that there are no "good brothers."

On the other hand, borrowing does not imply closing the account, and it is not necessary to use at one time all the loan rights; they may be split between several different loans. As a consequence, when loan rights are passed to a family member, those which come from a CEL may be split, whereas those which come from a PEL may not.

In other respects, the owner of a PEL may receive loan rights from other PEL or CEL owners, while a CEL owner may only receive loan rights from other CEL owners. In both cases, CEL have to be only 12 months old (not 18).

The PEL contract has proved remarkably successful and dominates the French EL system.

IMPORTANCE OF EPARGNE-LOGEMENT IN THE FRENCH ECONOMY

As a Savings Product

Epargne-logement has become one of the most important financial savings products in France. In 1996, 38% of households were holding at least one EL product; there were 11% just 20 years before.

Only savings booklets (80%) and life insurance or other long-term savings plans (45% but only 33% for life insurance strictly speaking) are more widely spread. By comparison, securities (shares, bonds and the like) could be found in only 22% of French households.

By the end of 1997, there were 15.5 million PEL and 7.8 million CEL. On average, two households out of three had a PEL and one out of three a CEL. The number of PEL increased by 15% in 1996 but only 7% in 1997, as interest rates on new plans were reduced at the beginning of the year.

At the same date, total EL deposits amounted to 1,224 billion Fr. (1,062 for PEL and 162 for CEL). The popular "livret A" (tax-free savings booklet), owned by 80% of French citizens, only amounted to 690 billion Fr. EL deposits increased by 13% in 1997 after a 21% gain in 1996.

This example shows how rapidly the situation may change, especially when the interest paid on savings becomes attractive; not only are new PEL opened but also deposits on existing plans increase. Nothing similar may happen in the reverse situation, as withdrawals on existing PEL are not allowed.

As a Housing Finance Instrument

In 30 years or so of existence, 13 million EL loans were granted, for an amount of more than 1 trillion Fr. Of these 48% financed second-hand (existing) housing, 26% were devoted to new housing and the same proportion to improvement or repair work.

During the year 1997, 761,000 EL loans were authorized (cf. 843,000 in 1996), totaling 47 billion Fr. (79 billion Fr. in 1996). The average loan amount fell from 93,500 Fr. to 62,000 Fr. The decline of market interest rates, becoming lower than those of PEL loans, is responsible for that decrease. Of the sums loaned, 24% financed new housing, 53% purchase of second-hand housing and 23% improvement or repair work.

The EL loans distributed in 1997 represented 16.5% of all new housing credit to households (286 billion Fr.); this share had reached 25% in 1997.

When an EL loan finances improvement or repair, it is frequently the only loan. When it finances the purchase of a housing unit, it is most often used in combination with other loans (see Table 2).

Table 2. Loan Combinations, 1995 (in percentages)

Loan Combinations	*Purchases*	*Works*
EL alone	16%	61%
EL and other	36	5
Without EL	48	34
Total	100%	100%

When used with other loans, the EL is typically one-third of the total.

As an Instrument of Public Support to Housing

EL premiums paid in 1997 amounted to 6.6 billion Fr., of which 60% were paid to good brothers, which means that only 40% are devoted to housing investment. EL premiums as a whole represent, on average, 20% of public support to housing investment (or "aid to bricks and mortar") and are comparable to the subsidies for social rental housing or for social ownership. Moreover, EL deposits are free of income tax. Income tax exemption was valued at 7.2 billion Fr. in 1996; that is more than 25% of all tax benefits for housing.

Tax exemption and premiums altogether approach 13 billion Fr., or 10% of total public support for housing. The importance of this amount is evidenced in that efforts have to be made in order to limit the budget deficit and meet the Maastricht criteria.[3] Furthermore, the needs for social housing are increasing, and EL advantages clearly benefit the middle and upper classes, which have the highest saving capacity.

STABILITY OF THE SYSTEM

The main risk for EL is cash-flow or liquidity risk. The possibility of a cash shortfall arises when the cash from new deposits and existing loan payoffs is insufficient to fund loan commitments. In the French system, stability comes from the liquidity provided by nonusers (good brothers).

Long-term stability requires that, on average, the ratio of good brothers within a generation of contracts is at least 60%. The problem is that, at a given time, the supervisory authorities may adjust the rate in order to make the savings more attractive but do not have any similar leverage on the demand for loans, as the interest rate on the new loans has been fixed by a contract signed several years ago. The only leverage that can be used when a liquidity crisis is expected is to extend contract maturities.

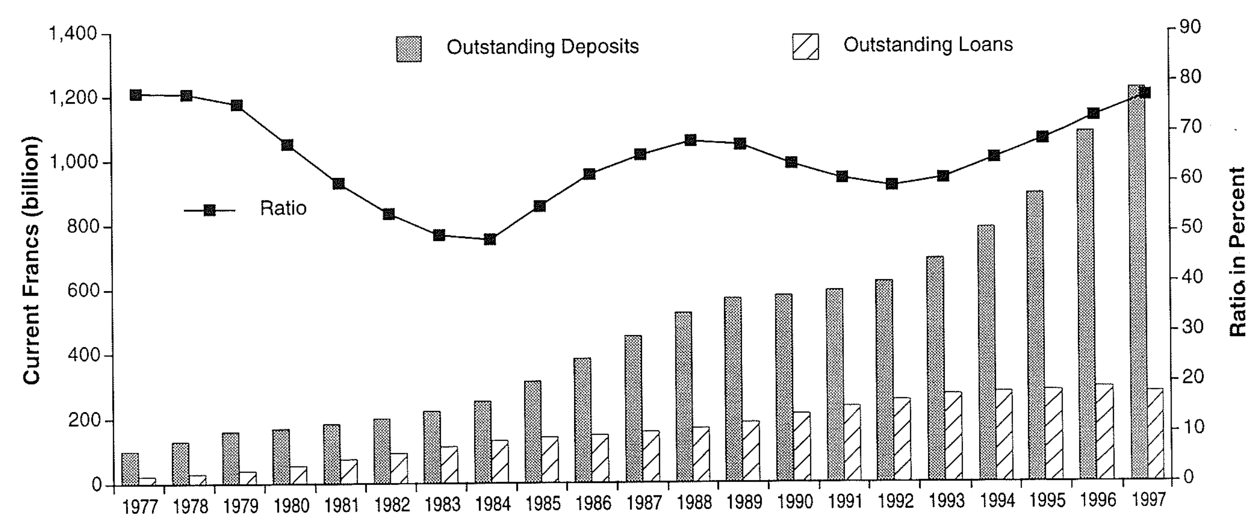
That situation occurred in the early '80s when inflation was over 10% and interest rates were over 15%. Until 1978, the system had peacefully grown up. In their early years, EL systems usually do not have any liquidity problem because many more contracts are signed than loans are granted. As PEL started in 1970, the first loans could not be taken out before 1974. But after 1977, three factors jeopardized the system:

- From 1977 to 1982, savings interest rates were always below the inflation rate; furthermore, these rates were far below after-tax bond yields, and good brothers fled toward financial markets.
- During the same period, interest rates of CEL and PEL loans were far below the inflation rate and rates of other loans (even subsidized loans); so, loan rights were used as much as possible.
- The government decided to extend contract maturity from four to five years in 1981; however, its impact could not be expected before 1985.

The maximum amounts for deposits and loans were no longer sufficient relative to the level of inflation. Strong measures were taken in 1983: the maximum deposit on PEL was doubled and so was the maximum loan.

The simplest indicator of the liquidity of the system used by the authorities is the "trésorerie" ratio, defined as one minus the ratio of outstanding loans to outstanding deposits. When this ratio declines, a liquidity crisis may occur. In fact, it dropped briefly under 50% in 1983 and 1984 (see Figure 1).

Figure 1. Trésorerie of Epargne-Logement



Since 1984, the "trésorerie" ratio has improved and it reached 77% at the end of 1997. Deposits have rapidly increased as the savings interest rate remained attractive because it was lowered with delay while market interest rates declined. On the other hand, the volume of new credit decreased: PEL that are presently reaching their term are permitted to borrow at a rate of 6.32%, which is more than 100 bp higher than the best fixed rates available on the market. Figures 2 and 3 show how PEL interest rates were adjusted to market evolution over a period of 20 years.

EPARGNE-LOGEMENT AND AGENTS' BEHAVIOR

Impact on Consumers' Behavior

The greatest attraction of EL for lenders probably lies in its capacity to lower credit risk. Indeed, a successful contract saver has demonstrated his ability to budget and set aside a portion of income for savings during an extended period (at least four or five years). Such a behavior indicates that he will probably also be a reliable borrower.

Thus, lending to an EL saver is less risky than lending to an average borrower. In addition, the existence of a substantial down-payment, obtained through contract savings, reduces the loan-to-value ratio and the probability of default, which is closely linked to it.

Indeed, in 1996 the average loan-to-value ratio was 70%. It reached 77% when the main loan was a social loan, 75% when it was a standard loan, but it was as low as 62% when it was an EL loan. General statistics on default rates are not available, but, according to all lenders, default rates on EL loans are particularly low.

Impact on Competition Between Lenders

Although all its rates and parameters are defined by the state, EL is available in any commercial or savings bank. Specialized credit institutions, on the contrary, do not have the structures that would enable them to collect savings on a large scale.

Moreover, most of them are too small to absorb the possible shocks created by the movements of fixed rates. For example, between mid-1983 and mid-1984, the banks had to pay a 6% interest rate on new PEL, while they were only receiving 5.5% from borrowers whose PEL had been opened after May 1977.

Signing an EL contract with a bank implies remaining a customer during at least six years, and, most often, between 15 and 20 years. It thus creates a long-term link between the customer and the bank.[4]

As EL products are the same everywhere, customers tend to sign such contracts with the bank where they have their current account. But the EL loan is seldom the main

Figure 2. Comparison between PEL Loan and Mortgage Loan Average Interest Rate

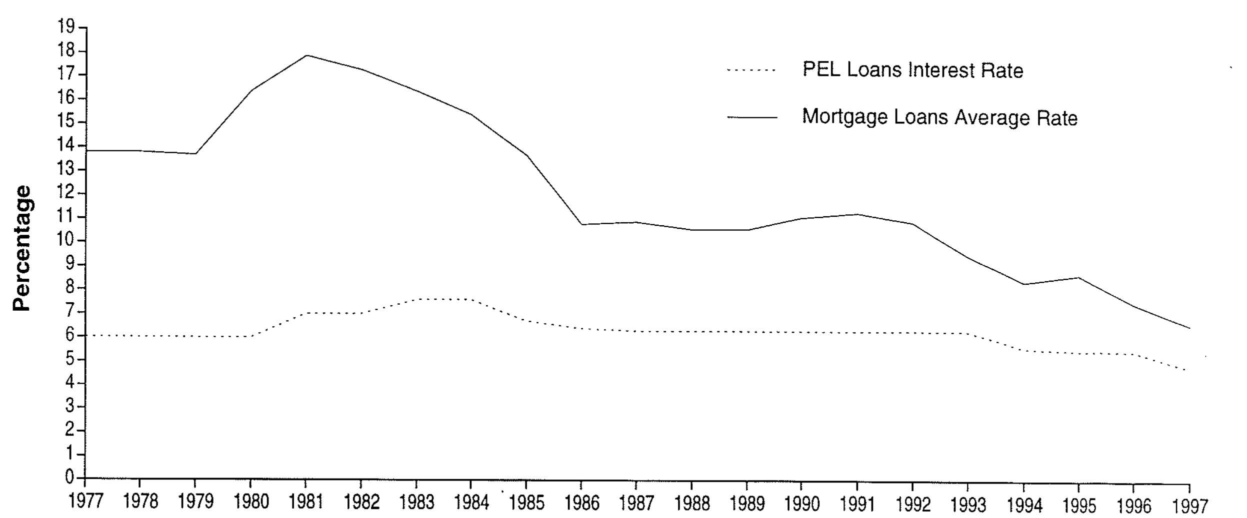
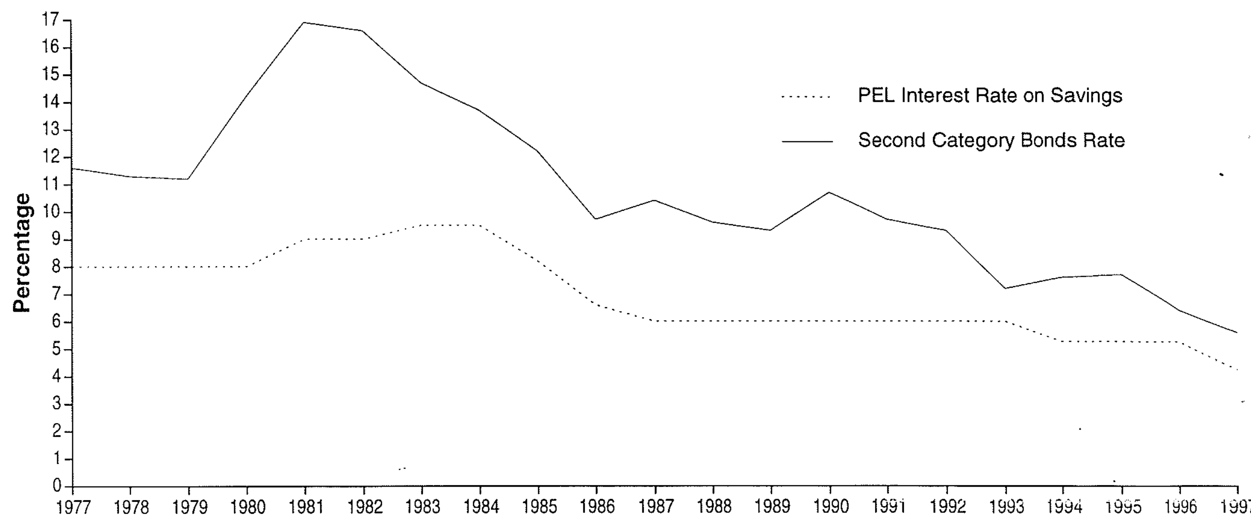


Figure 3. Comparison Between PEL Interest Rate on Savings and the Government Bond Rate



loan; so, tied by EL, the customer will often borrow his main loan from the same bank. This disrupts competition between banks and specialist lenders.

Moreover, when EL contracts generate a significant amount of excess funds, they can be used to fund other types of housing loans, which increases disruptive competitive consequences for specialist lenders who fund themselves through the capital markets and not through retail deposits. Such episodes of predatory competition took place first in 1986 to 1988.

In 1994 and since 1996, the deposit banks, intent on gaining market share, have been offering first mortgage loans at rates close to riskless government bond yields. They could only originate such underpriced loans with the use of below-market EL deposits.

CONCLUSION

The introduction of EL in France has undoubtably been a success, whatever indicator is used. It has facilitated the development of homeownership (the proportion of homeowners rose from 35% in 1970 to 54% in 1990) despite the limitation, until 1984, of long-term credit and a high level of inflation that tended to discourage efforts for saving.

Although it is favored by the banks because of the virtuous behavior it implies for consumers and the competitive advantage it gives them at the specialist lenders' expense, several criticisms are frequently made against the EL system:

- Its structural instability.
- The obstacle to the decrease of market interest rates it represents (with other state-backed savings products).
- Its cost to the national budget.

The question whether EL is still useful today in France deserves to be asked, despite the fact that it would be difficult to stop it, for political and technical reasons. The context in which EL have been launched, lack of long-term credit and previous savings, now completely belongs to the past. Money and financial markets now offer a wide range of possibilities to build savings and to fund long-term credit.

French lenders and borrowers are traditionally attached to fixed rates—the lenders precisely because they have an abundant fixed-rate resource with EL, the borrowers because consumer-protecting laws enable them to refinance at low cost when rates decline while benefiting from fixed rates when market rates rise.

Recently, however, preference was given to variable rates, when noticeable differences between short-term and long-term rates appeared and various safeguards, such as caps or the possibility to shift to fixed rates at no cost and at any moment, were introduced.

If evolution were preferred to revolution, there could be an agreement on one point: the introduction of variable rates that would bring some flexibility to the EL system. A variable rate system would reduce the cyclical instability in the system and make the system popularity more dependent on the rate of the state premium and thus controllable by the state.

NOTES

[1] After 10 years, it is not compulsory to close the PEL; no new deposit is allowed but those previously made still bear interest at a lower rate (and without state premium).

[2] Until recently; they remain free of income tax but are subjected to new social taxes (10% in 1998).

[3] However, only the premiums are a budget expense.

[4] A transfer from one bank to another is always possible.