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Enhancing the Benefits of Financial Liberalisation in Belgium

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ABSTRACT/RÉSUMÉ

Enhancing the benefits of financial liberalisation in Belgium

The Belgian financial landscape has been transformed over the past two decades and now consists of a relatively large, well-functioning and internationally integrated financial sector contributing directly and indirectly, through its intermediary function, to long-term economic growth. One of the financial system's key characteristics is the concentration of activity among a small number of financial conglomerates that offer a combination of banking and insurance services. Although this mix of activities may contribute to financial stability, it has led to a widespread commercial practice of cross-selling, possibly dampening competitive pressures. Competition may also be hindered by regulatory policies in the markets of mortgage loans and consumer credit; although these policies aim at protecting consumers against the risk of over-indebtedness, they risk having the unintended consequence of increasing entry costs for new providers, thus hindering competition and innovation and hurting consumer interests. Besides regulatory policy, tax policy has also been used to shape the development of the financial system. Tax credits are granted to influence investment and borrowing decisions, notably to stimulate home ownership, encourage saving and stimulate private pension accounts. International experience suggests that such tax expenditures, while influencing the allocation of saving, have no obvious impact on the overall level of saving. However they result in significant tax expenditure and necessitate higher tax rates elsewhere. Reforms recommended in this paper would help to make a well-functioning system perform even better.

JEL classification codes: G14, G18, G21
Key words: Information and Market efficiency, government regulation, Consumer Welfare, Competition

Renforcer les avantages de la libéralisation financière en Belgique

Le paysage financier belge s'est transformé au cours des deux dernières décennies et se caractérise aujourd'hui par un secteur financier relativement important, fonctionnant bien et intégré au niveau international, qui contribue directement et indirectement, par sa fonction d'intermédiation, à la croissance économique à long terme. L'une des principales caractéristiques du système financier est la concentration de l'activité au sein d'un petit nombre de conglomérats financiers qui offrent simultanément des services bancaires et des services d'assurance. Bien que cette combinaison d'activités puisse contribuer à la stabilité financière, elle a conduit à une pratique commerciale très répandue, la vente croisée, qui peut atténuer les pressions concurrentielles. La concurrence est peut-être aussi entravée par les dispositions réglementaires concernant les marchés du crédit hypothécaire et du crédit à la consommation ; bien que ces dispositions aient pour objet de protéger les consommateurs contre le risque de surendettement, elles peuvent avoir pour conséquence involontaire d'accroître les coûts d'entrée pour les nouveaux prestataires, et de limiter ainsi la concurrence et l'innovation tout en portant atteinte aux intérêts des consommateurs. Outre la politique réglementaire, la politique fiscale a été utilisée pour façonner le développement du système financier. Des crédits d'impôt sont accordés pour influencer les décisions d'investissement et d'emprunt, en particulier afin de stimuler l'accession à la propriété du logement, encourager l'épargne et promouvoir la constitution de comptes retraite privés. L'expérience d'autres pays donne à penser que ces dépenses fiscales, si elles influent sur l'affectation de l'épargne, n'ont pas d'impact manifeste sur son niveau global. Or, elles se traduisent par d'importantes dépenses fiscales et obligent à relever les taux d'imposition dans d'autres domaines. Les réformes recommandées dans le présent article contribueraient à améliorer encore le fonctionnement du système, qui est déjà satisfaisant.

Classification JEL : G14, G18, G21
Mots clés : Efficacité de la Communication et du marché, réglementation de l'administration concurrence de l'aide sociale.

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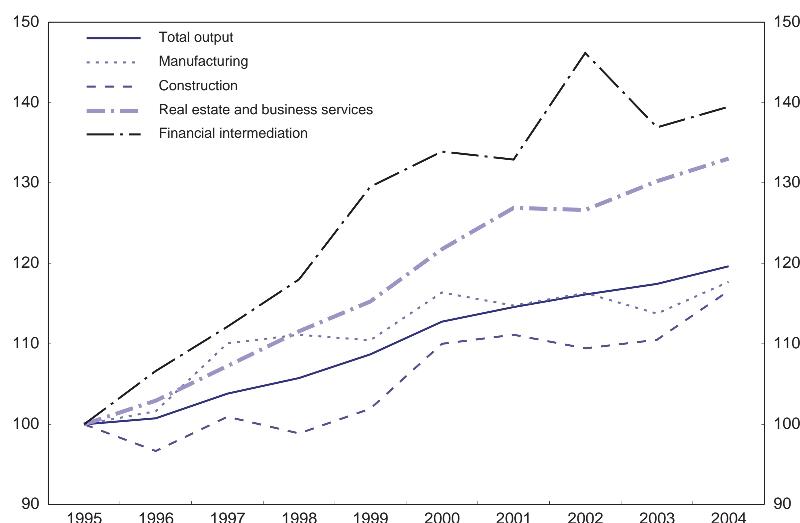
ENHANCING THE BENEFITS OF FINANCIAL LIBERATISATION IN BELGIUM

By Stefan Ide, Jens Høj and Patrick Lenain[1]

1. The Belgian economy enjoys the benefits of having a relatively large, well-functioning and internationally integrated financial sector. The sector comprises four large conglomerates offering banking and insurance activities, the Euronext Brussels stock market and a variety of other important private entities. The financial landscape has been transformed over the past two decades by reforms to liberalise international flows, privatise banks and deregulate financial and insurance activities. An additional factor behind this transformation is the ongoing integration of financial markets in Europe. Although measurements of the financial sector's output are subject to large margins of errors, the difference between the growth of the financial intermediation sector's value-added in real terms during the past ten years (3.8% per year) and that of the overall economy (2%) leaves no doubt as to its underlying dynamism (Figure 1). Other activity indicators confirm this dynamism.[2] The financial stability of the sector over the past twenty years – it has avoided the type of large bank crises observed in some other countries – has also been an important contributor to overall prosperity.

Figure 1. Real value-added by sector

1995 = 100



Source: NBB, Belgostat.

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1. This paper was originally prepared for the OECD *Economic Survey of Belgium* which was published in March 2007 on the responsibility of the Economic and Development Review Committee. The authors are grateful to colleagues in the OECD, especially Jørgen Elmeskov, Andrew Dean and Val Koromsay. Special thanks to Laure Meuro for her technical assistance. The authors can be contacted at Jens-Christian.Hoj@oecd.org

2. Loans granted to households have increased by 35% since 1999 and loans to small firms by 56% over the same time period. In the insurance sector, per capita life insurance premiums have increased by 166% between 1996 and 2003.

2. While the system's direct contribution to output is notable, its *indirect* contribution is all the more important. As suggested by recent empirical studies, a well-functioning financial system contributes to long-term growth through various channels (Leahy *et al.*, 2001; de Serres *et al*, 2006). This includes mobilising large volumes of domestic and international savings, allocating them adequately, spreading risks across the economy and monitoring the users of external funds. In addition, a well-functioning financial system can enhance economic resilience by helping consumers borrow their way through downturns to stabilise spending and thereby economic activity. The evidence presented in this chapter suggests that Belgium's financial sector generally fulfils these functions adequately, but that there is room for improvement. Key features that risk hindering overall economic performance are the high concentration of activity among a small number of institutions, the relatively strict stance of credit regulations, particularly for mortgage and consumer credit, and the large-scale use of tax incentives to influence financial decisions. The chapter addresses these issues and recommends various further reform measures that could help to spur long-term growth.

The financial system is highly concentrated

3. As measured by the distribution of assets, Belgium's financial sector appears dominated by banking institutions, (Figure 2). The banking system itself is highly concentrated among a small number of entities, which offer both banking and insurance services and therefore have been qualified as "bancassurance conglomerates". Past mergers and acquisitions have left the sector largely in the hands of four such institutions, which offer a wide range of retail financial services, providing personal clients with the equivalent of a one-stop financial service centre.[3] The four conglomerates hold about 80% of the country's banking assets, as compared to an average of 45% for the largest five banks in the EU–15, which makes the Belgian sector a highly concentrated one (Allen *et al.*, 2005). This assessment needs to be qualified to take into account the size of the country, because there is less room for banks to operate with sufficient economies of scale in small countries. Indeed, the degree of banking concentration in Belgium is comparable to that of the Netherlands and Finland (Figure 3). Nonetheless, there are small countries (Austria, Denmark, Ireland and Greece) where less concentrated banks appear to operate profitably.

4. While the banks have transformed themselves since the early 1990s, data from the financial accounts suggest that the composition of their funding has remained stable and that banks rely heavily on the household sector to fund their activities (Figure 4). However, these data do not include interbank market transactions and, being on a territorial basis, cover only branches and subsidiaries operating in Belgium. Hence, the data potentially overestimate the importance of the household sector. Nevertheless, such resources are stable and less costly to mobilise than other external funds, while at the same time exploiting the extensive existing retail branch networks. Thus, safeguarding this source of financing is an important aspect of the banks' business model and an essential factor of their profitability.

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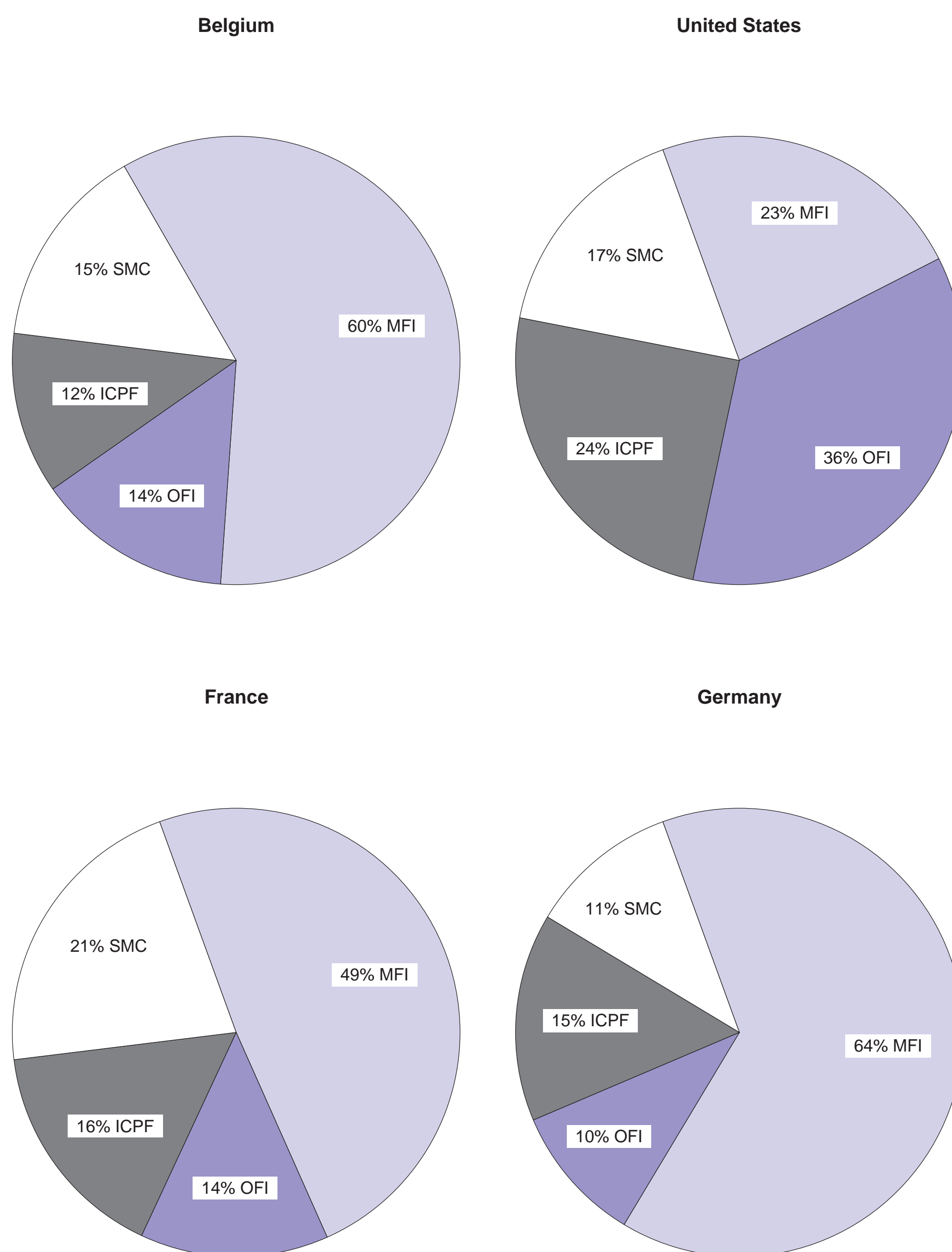
3. *Fortis* is a large Belgo-Dutch institution. The Dutch group *ING* has a strong presence in Belgium, via its subsidiaries ING Bank Belgium and ING insurance Belgium. *Dexia* is a Belgo-French Group. The Belgian-owned *KBC* has a strong presence in the financial markets in Central and Eastern Europe.

Figure 2. Assets of financial intermediaries

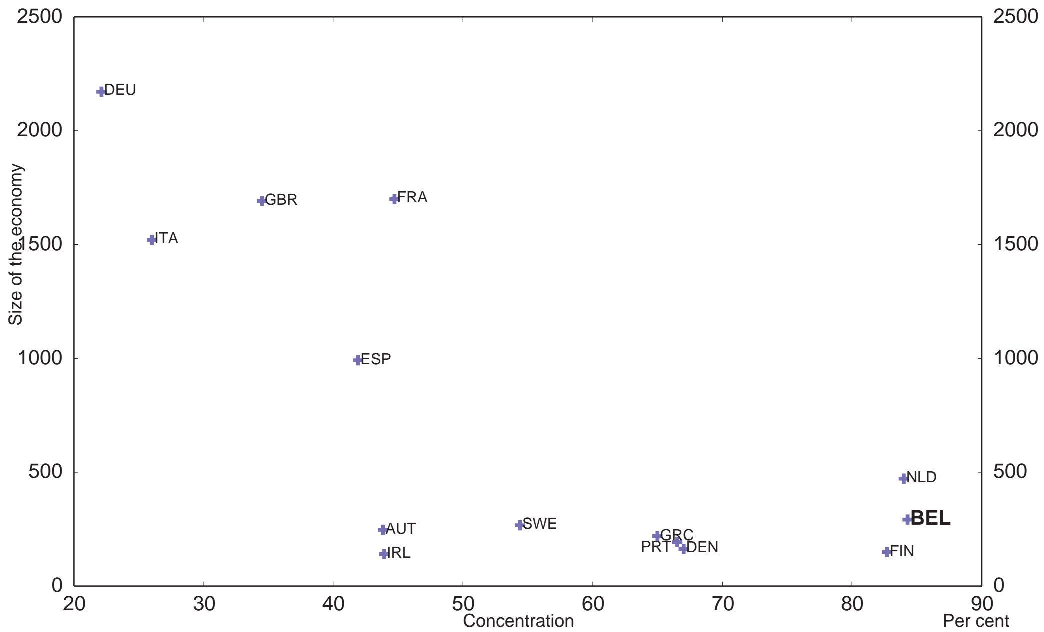
As per cent of total financial assets, 2004



Note:
MFI: Monetary financial institutions.
OFI: Other financial intermediaries.
ICPF: Insurance corporation and pension funds.
SMC: Stock market capitalisation.

Source: OECD Financial Accounts, Euronext, Allen *et al.*(2005).

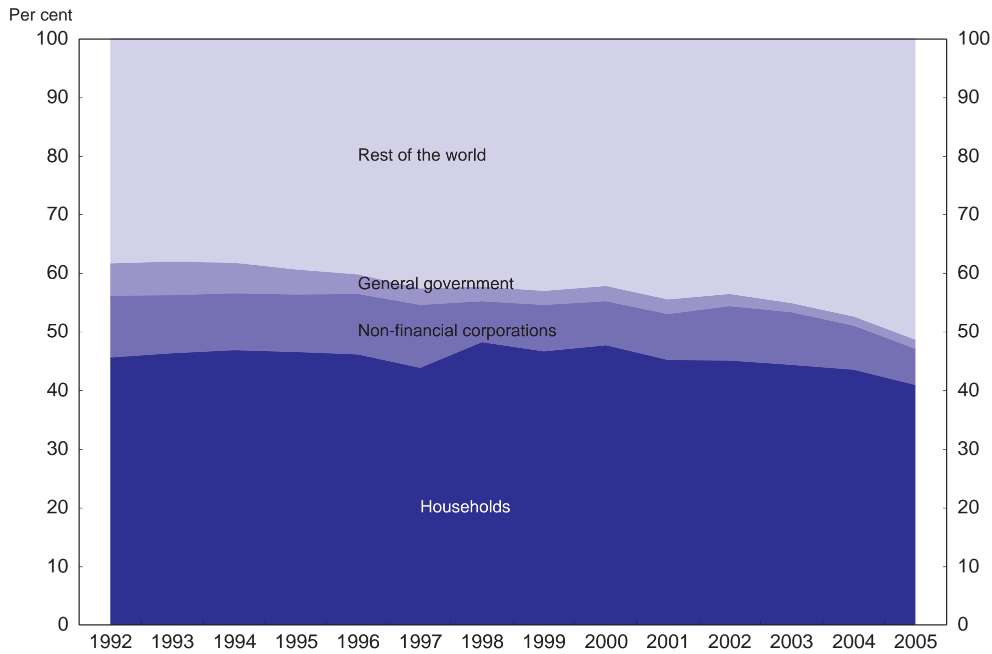
Figure 3. Concentration in the banking sector and size of the economy[1]



1. Concentration ratio refers to the five largest institutions' share of total bank assets, 2004. The concentration ratio of the three largest banks of some major non-European countries is 30% (USA), 39% (JPN) and 53% (CAN). Size of the economy is measured by GDP volume at PPP, billions of USD, 2005.

Source: OECD, Allen *et al* (2005).

Figure 4. Decomposition of banks' liabilities by type of claimant[1]
In per cent

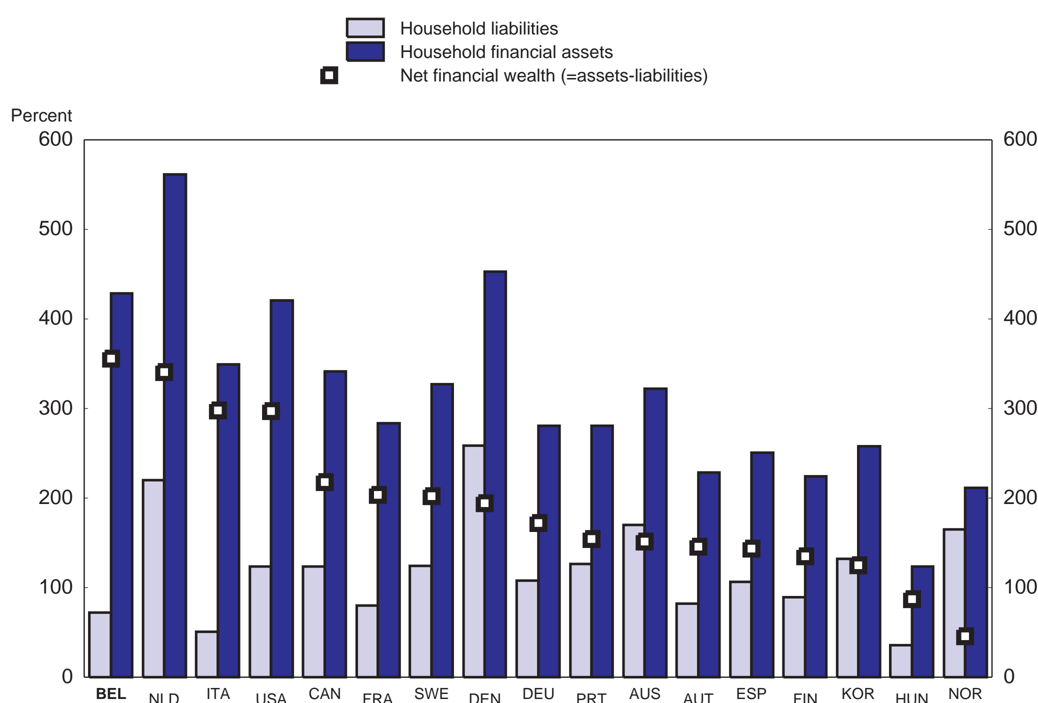


Source: Financial Accounts of Belgium, Belgostat.

5. The fact that households bring such large resources to the financial system is not entirely surprising. The Belgian household sector is characterised by a high savings ratio and, consequently, by a large level of accumulated net worth by international standards, with gross financial assets of more than 400% of gross disposable income compared to financial liabilities of less than 80% (Figure 5). In addition, the household sector owns housing wealth of also approximately 400% of gross disposable income, which makes aggregate net wealth very large in comparison to other countries. The accumulation of wealth partly reflects the persistently high volume of household saving, which may have been a reaction to the ongoing accumulation of large public debts (IMF, 2006). However the household savings ratio has declined from over 20% in 1995 to below 14% in recent years, partially reflecting the balancing of the budget over the past half decade. The fact that households tend to accumulate large amounts of saving may also be linked to the low replacement rates provided by the first-pillar pension scheme, which may have encouraged households to invest in second and third-pillar schemes (such as life-insurance products) as well as by the persistent high degree of unemployment, which may encourage a high level of precautionary saving.

Figure 5. Household financial balance sheet

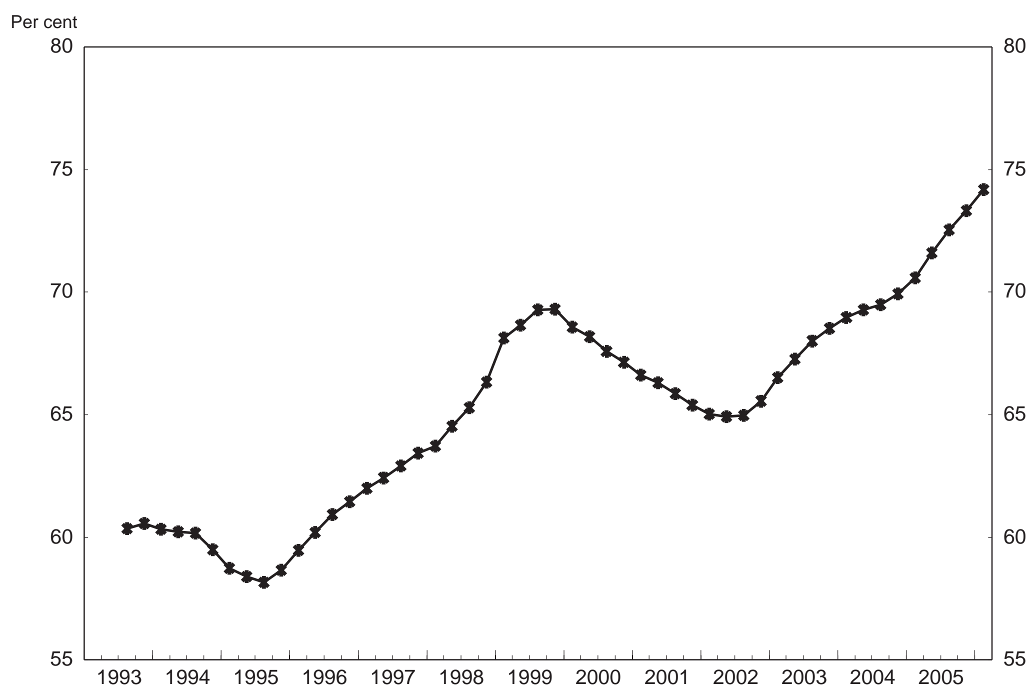
As a percent of disposable income



Source: OECD, Financial Accounts.

6. Like in other countries, the household sector has sharply increased its borrowing during the first half of the decade (Figure 6). Activity in the mortgage market has been particularly buoyant as households took the opportunity of low mortgage rates to increase their borrowing, while the take-up of other forms of debt (such as consumer loans and term loans) showed a more moderate increase. As a result, the household debt-to-income ratio has reached the record level of 75% in early-2006 and the share of mortgage debt in total household indebtedness rose to an unprecedented level of 72%. The net financial wealth of the aggregate household sector nevertheless remains extremely high and the recent sharp increase in house prices implies that total wealth is rising fast.

Figure 6. Household debt
In per cent of gross disposable income



Source: OECD Analytical Database.

7. In contrast to the household sector, the *corporate sector* has further reduced its borrowing from the domestic banking sector. The importance of bank credit to Belgian firms as a share of GDP has declined in the past five years and stands well below the corresponding ratio for firms located in the euro area. Medium- and large-sized firms have access to the international credit market and make a limited recourse to the domestic banking system. Similarly, the corporate sector resorts only to a limited extent to the domestic stock market. Indeed, the Belgian stock market capitalisation is relatively small by international standards (Figure 7) and at the same time liquidity (measured by shares turnover ratio of stock traded) is on the low side (Allen *et al.*, 2005)[4]. Factors that limit the number of quoted shares are the high number of smaller companies with a family shareholder structure and the issuance of unquoted shares in connection with inward foreign direct investment and venture capital funds (Baugnet and Wuyts, 2006). The combination of these factors is behind the limited free float (*i.e.* the shares that available for trading) on the Belgian subsidiary of Euronext.[5]

8. All of this suggests that domestic financial market activities (such as equity issuance or bond floatation) play a less important role as a long-term growth driver than bank credit; this appears to be

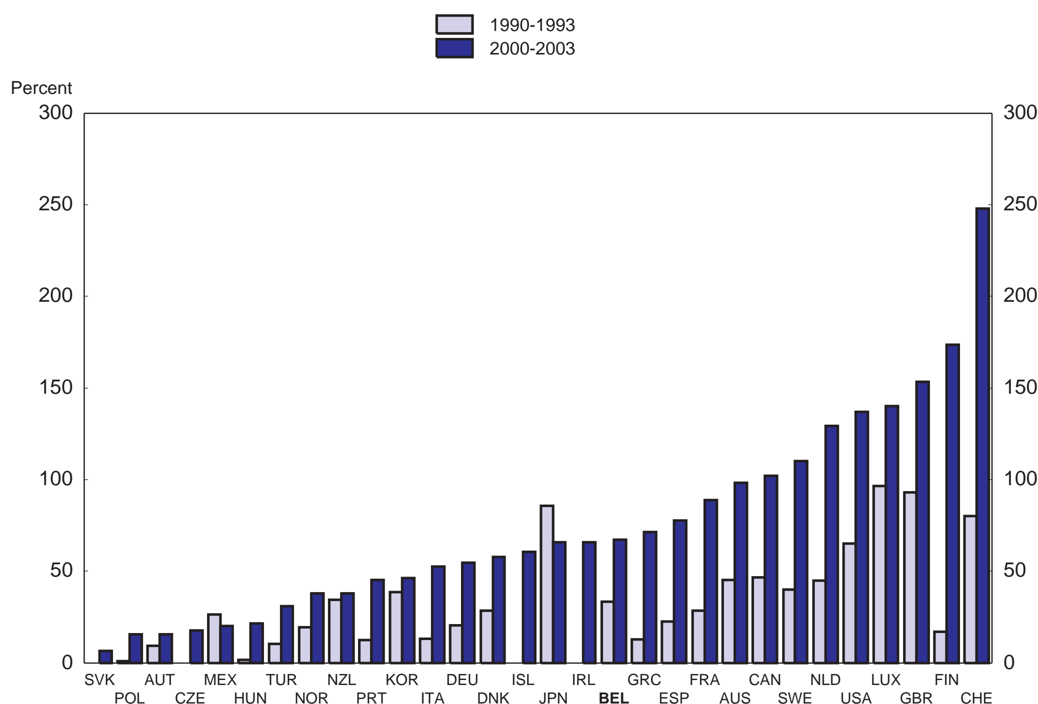
4. The limited availability of quoted shares is partly the result of the historical prevalence of industrial conglomerates (so-called *holdings*). These holdings typically organise their portfolio to keep controlling equity stakes in a number of companies from different sectors and diversify their risk exposure. As a consequence, these substantial amounts of shares are unavailable for day-to-day trading. However, the importance of holdings is diminishing.

5. Over the period 1995–2005, quoted shares accounted only for 5% of the cumulative new liabilities of non-financial corporations.

confirmed by an empirical assessment comparing the roles of intermediated and disintermediated financing in Belgium and the United States (Ernst and Compton, 2007).

Figure 7. Stock market capitalisation in OECD countries

Per cent of GDP



Source: World Bank financial structure database.

9. The financial stability of banks is underpinned by a number of Belgium-specific features, such as the system's large (though diminishing) holdings of government securities, banks' stable sources of funding *inter alia* from household accounts and a traditionally cautious attitude towards risk (NBB, 2006a). The overall soundness of the financial intermediaries has been confirmed by the results of stress tests (simulating large shocks to the system) run by the main financial institutions, the National Bank, and the financial supervisor, in coordination with the IMF. A contributing factor has been the ongoing reform of financial supervision (see Box 1).

Box 1. Financial supervision

In 2004, financial sector supervision of banking, finance and insurance was merged into a single supervisor (the Banking, Finance, and Insurance Commission, CBFA), to further strengthening the supervision of the increasingly complex and continuously evolving strategies of the *bancassurance* groups and of the trend towards greater cross-border activities. The creation of a single supervisor should increase the quality of supervision as well as improve consistency of supervision across sectors (Cihak and Podpiera, 2006). Moreover, the Financial Stability Committee (FSC) was created, bringing together all the board members from the CBFA and the National Bank of Belgium, in order to complement micro-prudential surveillance and macro-prudential analysis. This includes the global stability of the financial system, crisis management co–ordination and co–ordination of the supervision of financial conglomerates.

The *bancassurance* business model may impede competition

10. A particular feature of the Belgian financial system is that the four major institutions offer a combination of banking and insurance services. Bank customers can therefore combine traditional banking operations with insurance transactions (notably investments in life-insurance schemes). Banks typically offer a package of services to their clients within an overall pricing strategy, thus cross-selling their services and products. This business model has many virtues, notably because it contributes to reducing operating costs for the banks and makes it possible to build large databases on the main characteristics of each client, thus helping to develop specific products and better satisfy the customer's needs. The marketing literature also points to cross-selling as being a key tool for forging stronger relationships with customers and reducing customer "churn" (Kamakura *et al.*, 2003). This is because the selling of additional products by the vendors increases the switching costs for the customer and therefore reduces the probability that the customer will switch to a rival institution in response to a more competitive offer.

11. The authorities view the business model of *bancassurance* as a risk diversification measure, which contributes to strengthening the robustness of the system (NBB, 2006a). The cycles in the banking and insurance markets tend to move in different directions due to differences in duration of assets and liabilities in banking and insurance. Thus, the cross-selling of banking and insurance services adds to financial stability. Even though insurance activities are less important than banking activities for the four main conglomerates, they nevertheless constitute an important source of asset diversification and corporate earnings (Table 1). The widespread practice of cross-selling however, risks dampening competitive pressures because it blurs price transparency and strengthens consumer loyalty. In the market segment for large corporate borrowers, the high concentration in the banking sector has not come at the cost of restraining competition because large corporations are able to access international financial markets. For households, however, there is little choice other than dealing with domestic banks, which, particularly the largest ones, tend to follow similar business models.[6]

Table 1. Relative importance of banking and insurance activities
Percentages

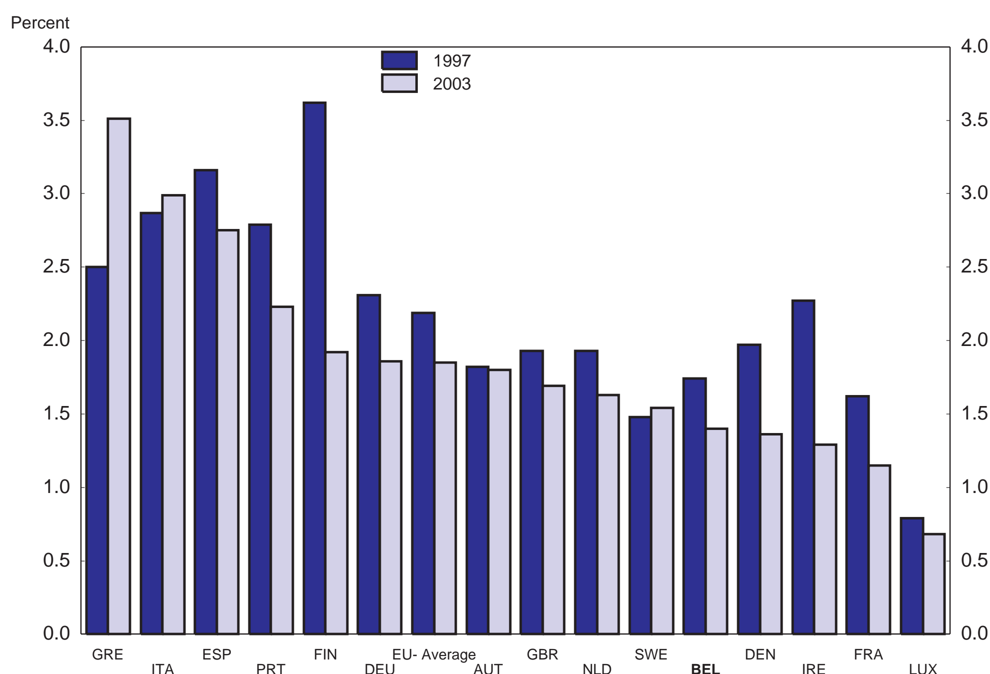
	Market share in Belgium[1]		Contribution to group profit[2, 3]		Share of total assets[3]	
	Banking	Insurance	Banking	Insurance	Banking	Insurance
Dexia	14.7	6.4	81.1	18.9	93.1	6.9
Fortis	31.9	17.8	66.5	33.5	85.7	14.3
ING Belgium	14.0	6.7	84.4	15.6	93.3	6.7
KBC	21.4	13.4	80.7	19.3	91.2	8.8
Total	*82.0*	*44.3*	–	–	–	–

1. On the basis of deposits by Belgian residents for banking and collected premiums for insurance.
2. Percentages of the group's net operating profit.
3. Data for 2005.
Source: NBB (2006a).

6. A high number of foreign (specialised) financial institutions are operating on the Belgian market, evidence of the high degree of internationalisation of the Belgian economy (revealed by, among other things, the substantial inward FDI-flows and the large number of foreign workers). Nevertheless the market share of the four largest for the major *bancassurance* conglomerates in the major retail segments (saving deposits, sight deposits, mortgages) remain high and relatively stable.

12. In principle, the number of banks is large enough to support competition and, as judged for instance by the very low level of net interest margins, the market for retail banking appears to be competitive (Figure 8). However, such low margins could reflect a strategy of generating income through banking fees rather than covering management and transaction costs through interest margins. Indeed, credit institutions' net income is equally divided between net interest income and non-interest income (NBB, 2006a). This may reflect the fact that bank customers are offered low-interest credit products (such as mortgage loans) and interest-earning savings accounts cross-sold with fee-based services (such as life-insurance and mutual fund investments) (Figures 15 and 9).[7] As noted above, the strategic marketing goal of cross-selling products is to increase the switching costs for customers, thus reducing the probability of their escape toward more competitive rivals. Such cross-selling may include aggressive pricing on mortgage loans or savings accounts, which are cross-sold with other products. Thus, financial services providers tend to compensate their low net interest margins with income from cross-sold banking and insurance products. An additional concern is that customers may be offered an overall package of products – comprising new credits, savings accounts, insurance coverage, investment products – at conditions that reflect the outcome of negotiations with the customer, thus reducing the transparency of the prices of individual products for the client (though not for the service provider). So although there may be economies of scope from cross-selling, it is unclear – in the absence of price transparency – that such efficiency gains are actually passed on to the customers. While such practices are not confined to Belgium, they are reinforced by the specific nature of the *bancassurance* business model.

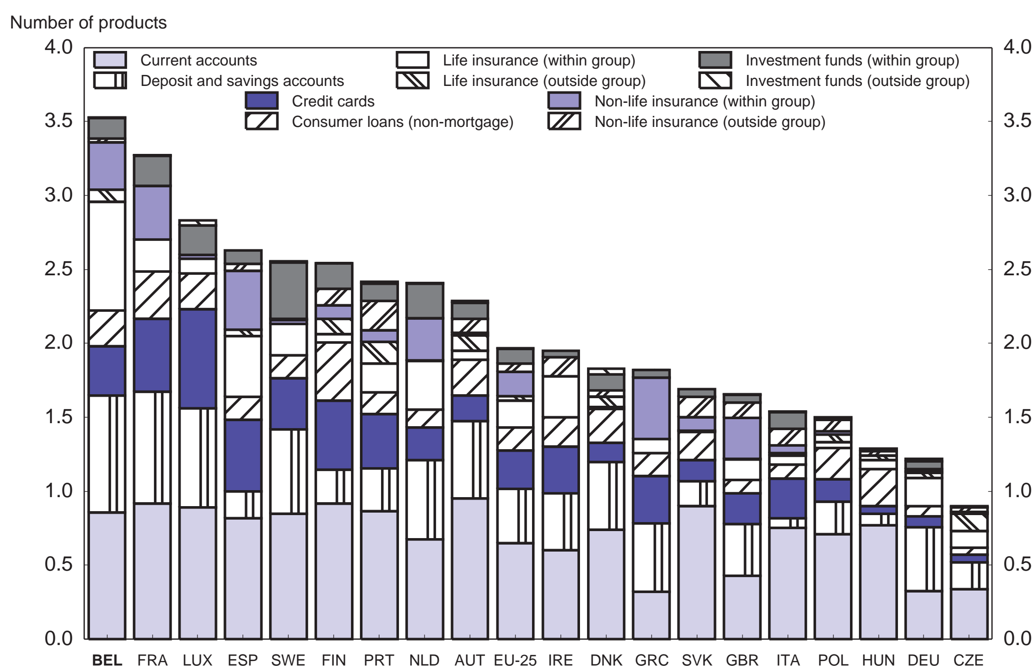
Figure 8. Net interest margins
In per cent of total banking assets



Source: BankScope (taken from Allen, Bartiloro, Kowalewski (2005)).

7. The data for Figures 9, 10 and 13 were taken from the European Commission Retail Banking Survey which was published in the interim report II "Current accounts and related services". The latter document was published within the framework of the European Commission's inquiry into competition in financial services, pursuant to Article 17 of Regulation (EC) No. 1/2003. The financial services sector enquiry focuses on three areas: payments cards, core retail banking and business insurance. The Retail Banking Survey was based on a sample of around 250 banks that covered each of the 25 Member States.

Figure 9. Mortgage cross-selling[1]



1. Cross-selling is measured as the average of products that customers purchasing a mortgage are purchasing from the same financial institution.

Source: European Commission, "Retail Banking Survey", 2005–06.

13. While cross-selling may be a rational strategy for both banks and customers, tying of financial products is potentially harmful for competition (European Commission, 2006). Although in general tying of financial products is explicitly forbidden in Belgium, there is one exception in the mortgage credit law: mortgage loan providers are allowed to grant a conditional interest rate reduction if a life insurance ("*l'assurance de solde restant dû*") and/or a home insurance is bought from the same financial institution.[8] As a result, the closure of a mortgage contract is a bargaining process, with reduced transparency, which is likely to be at the detriment of consumers as they end up with tied products and high switching costs if they want to escape to a rival at a later stage. It is for the purpose of discouraging anti-competitive cross-selling practices that the authorities should reconsider the regulation of authorising mortgage interest rate reduction conditional on the joint purchase of insurance products.

14. In February 2004, the Belgian authorities concluded a "gentleman's agreement" with the Banking Association that includes a commitment to improve price transparency and make comparisons easier. Despite this agreement, it appeared that more was needed to spur competition. Thus, in June 2006 the Council of Ministers adopted a draft law – anticipating European regulation – that allows depositors to close a bank account or a saving account without incurring fees and be reimbursed for any banking fee paid in advance for future services. Such measures aimed at reducing switching costs go in the right direction and should be complemented by the forceful implementation of the competition law in the financial markets by the competition authority. An important step in this direction is the request from the

8. This insurance serves to finance outstanding housing debt in case the borrower's decease prior to full repayment.

government to the competition authorities to examine competitive pressures on the market for savings account.

15. It has often been argued that stronger competition in financial markets could conceivably have adverse implications for the stability of financial institutions and hence economic stability. However, there is no evidence that OECD countries with vibrant competition are more prone to instability then countries with more muted market forces (De Serres *et al.*, 2006). Indeed, Beck *et al.* (2004) find that fewer regulatory restrictions – lower barriers to bank entry and fewer restrictions on bank activities – lead to less banking fragility, suggesting that regulatory restrictions are not beneficial in the stability dimension. Moreover, Degryse and Ongena (DAF/COMP/WP2 (2006)7) argue that supervisory authorities have increased their ability to support stability through prudential/capital regulation (Basle I and Basle II). Moreover, the competition authorities are engaged in applying a common set of competition principles across the economy, thus securing an even-handed approach.

Policies to regulate household borrowing may hamper consumption smoothing

16. Another type of regulation that has shaped the development of the financial system is consumer protection policy – *i.e.* protecting borrowers against the risk of over-indebtedness – notably in the areas of mortgage loans and consumer credit.

Mortgage debt regulation

17. Housing wealth is the most important component of most households' assets and mortgage debt represents a correspondingly large share of their liabilities. In many countries, financial innovation has helped households tap their housing equity to compensate for temporary fluctuations in income. In downturns, consumers can maintain their spending in a variety of ways using housing finance (such as contracting a mortgage loan to renovate a house, taking a second mortgage loan, reloading an existing mortgage loan, taking home equity credit lines, trading down to a smaller house, moving to a rental, etc.). This requires an efficient mortgage market, a well-functioning real estate market and a relatively flexible regulatory environment. This is particularly important for liquidity-constrained households, who are not able to draw down short-term assets (such as bank accounts or savings deposits). In Belgium, however, the combination of banking practices and government policies appear to prevent this from happening, with the risk of hindering consumption smoothing (Box 2).

18. In Belgium, banks do not offer equity withdrawal loans, although there is no regulation prohibiting them from doing so (Table 3). Almost all mortgage loans offered are of the "mortgage credit opening" type. This type of mortgage loan allows a reloading of new credit up to a maximum of the original loan amount. This lets people obtain fresh resources, but only after years of repayment of the principal and excludes the possibility of taking advantage of capital gains in owner-occupied housing. As a result, the possibilities for smoothing consumption through equity withdrawal are limited. Equity withdrawal in the form of reverse mortgage can also be used by older people to cash in on their housing wealth and obtain a stream of revenue supplementing their pension income.[9] This could be of particular interest in Belgium, where second- and third-pillar pension funds are not very well developed and where the replacement rate of the first-pillar pension system is among the lowest in the OECD.

9. The introduction of reverse mortgages on the Belgian financial market is currently under consideration.

Box 2. Consumption smoothing

Economic theory and empirical studies suggest that people like to spend in accordance with their expected lifetime income. In aggregate, people do not fully adjust their spending to changes in their income: they save more when their income is temporarily high and they save less and/or borrow more when their income is temporarily low. There is some controversy as to whether rich and poor people act differently, but there is agreement that consumption smoothing is a goal sought by people in aggregate. For consumers to keep their spending unchanged in the face of income changes, the financial system has to function efficiently, especially for liquidity-constrained people. An efficient financial sector can therefore make an important contribution to the reduction of output volatility and to the resilience of economies in the face of economic shocks. There is evidence that financial innovation has lowered output volatility by making it easier for consumers to tap the credit market and borrow their way during economic downturns (Dynan *et al.*, 2006). To find empirical evidence on the behaviour of consumers, empirical studies estimate the sensitivity of private consumption to changes in real income. A high marginal propensity to consume (so-called "excess sensitivity") may indicate, on the supply side, that the financial system does not provide efficient services to people seeking to smooth their consumption or, on the demand side, a conservative attitude towards borrowing for consumption. By contrast, a low sensitivity to changes in real income suggests that people can and will use the financial system efficiently to maintain their spending when their income fluctuates. According to existing empirical studies, Belgian households show a relatively high excess sensitivity (Table 2). As opposed to the low sensitivity of spending in the United States, the United Kingdom and northern Europe, there is some degree of excess sensitivity in western Europe, and particularly in Belgium.

Table 2. Estimated excess sensitivity of consumption to disposable income[1]

	1990	1999
Belgium	0.92	0.85
Italy	0.80	0.84
Canada	0.44	0.48
Austria	0.50	0.53
Denmark	0.47	0.41
Netherlands	0.48	0.57
Spain	0.40	0.39
United States	0.39	0.16
Finland	0.06	0.06
France	0.33	0.45
Germany	0.40	0.53
Japan	0.31	0.28
Sweden	0.27	0.26
United Kingdom	0.26	0.24

1. Excess sensitivity (λ_t) was estimated by the linear specification $\Delta c_{jt} = \alpha_j + \lambda_{jt}\Delta y_{jt} + \varepsilon_{jt}$ and $\lambda_{jt} = \beta_0 + \beta_1 b_{jt} + \beta_2 FL_{jt}$. With *c* private consumption, *y* household disposable income, *b* ratio of government debt to GDP and *FL* per capita number of credit cards.

Source: Pozzi *et al.* (2004).

Table 3. Mortgage markets: general characteristics

	Typical rate structure	Recent/ peak LTV ratios (per cent)[1]	Typical term (years)	Prepayment fees	Equity release products	Tax regime[2]	Owner occupation (per cent)
Belgium	Fixed	80/115	20	Capped at 3-months interest	Not used	Ded, IT	68
Denmark	Fixed	80	30	Administration fee only	Used	Partial Ded; WT; IT	51
France	Fixed	67/100	15	Limited to 3% of repaid principal	Not used	WT; IT	56
Germany	Fixed	67/80	25	Lender entitled to compensation for lost income[3]	Not used	IT	43
Japan	Fixed	85/100	25	Lender entitled to compensation for lost income	Limited use	Limited term Ded; WT; IT	n.a.
Netherlands	Fixed	90/115	10	No fees up to 10% of capital prepaid each year	Used	Ded; IT	55
United King dom	Floating	69/110	25	Usually no fees	Used	IT	69
United Stat es	Fixed/ Floating	80/100	30	Usually no fees	Used	Ded; IT	68
Canada	Fixed/ Floating	75/100	25	Penalty fees. No charges on portable mortgages.	Not used	No taxes, no deductibility	n.a.

1. Maximum LTV for eligibility to Realkreditobligationer in Denmark. Obligations Foncières in France and Pfandbriefe in Germany are 80%, 60% and 60%, respectively.

2. Interest Deductibility (Ded); Wealth Tax on housing (WT); Inheritance Tax on housing (IT). In most countries, capital gains are taxable. However, owner-occupiers also benefit from various degrees of tax exemptions after a number of years of occupation.

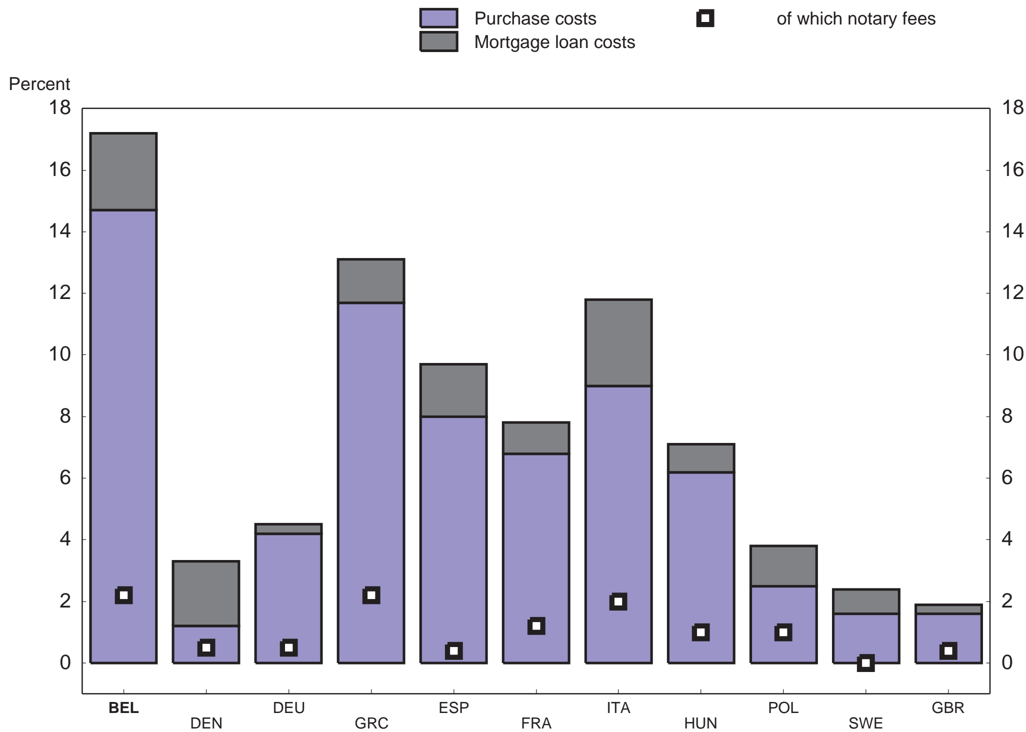
3. In the first ten years of the loan.

Sources: MOW (2003); European Mortgage Federation (2005); IMF staff estimates.

19. Another way to draw down housing equity is to sell one's house – so as to trade down to a smaller house or temporarily use rental accommodation. However, high transaction costs are likely to act as an impediment. Such costs amount to approximately 18% of the purchase value (reflecting both relatively high registration taxes and relatively high notary fees) making them among the highest in the OECD (Figure 10). These costs contribute to the low number of transactions (Figure 11) and hence fewer market opportunities are available. Indeed, many homeowners purchase only one house in their lifetime, implying that there is little adaptation of housing to variation in family size. The high transaction costs also contribute to explaining the very low geographical labour mobility (see Chapter 3). To address such problems Flanders recently introduced a system of portability of transaction costs within the Flemish region (Box 3).[10] Further lowering of real estate transaction costs would stimulate the housing market and thus the market for mortgages – in the process creating opportunities for entry of new mortgage providers.

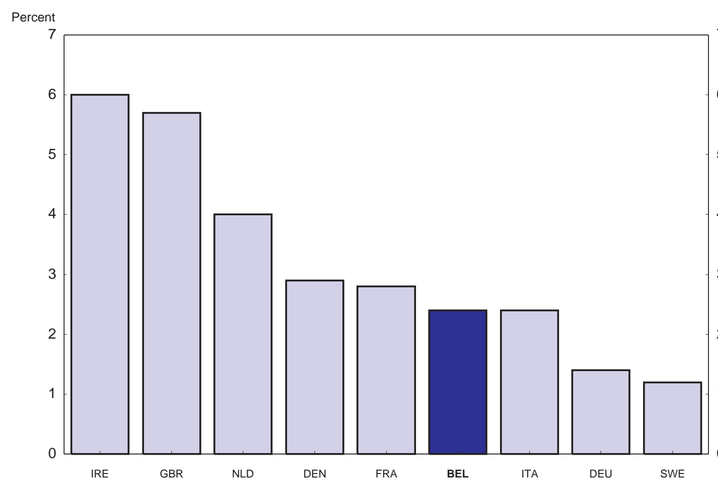
10. The European Commission is concerned that this may lead to tax discrimination as citizens who move from another EU-Member State to Flanders and buy a house there cannot get a credit for the registration

Figure 10. Total transaction costs as percent of total house purchase costs



Source: European Mortgage Federation (2006a).

Figure 11. Average annual turnover of housing stock[1]



1. The average annual turnover of housing stock has been calculated by dividing the simple average of the number of transactions during the last ten years (1995–2004) by the simple average of the total dwelling stock during the last ten years.

Source: European Mortgage Federation (2004).

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tax that they had paid on the purchase of a house in their Member State of origin. In early 2007, the European Commission decided to refer Belgium to the European Court of Justice.

Box 3. Transaction costs in Belgium

The 18% transaction cost consists of the following elements: a 12.5% registration tax, a 2.5% notary fee and a 3% real estate broker fee. In some cases, the cost may be lower, as not all real estate transactions are brokered by real estate agents and registration tax is lowered to 6% for modest houses, *i.e.* houses with imputed rentals of less than € 750.[1] In 2002, the region of Flanders reduced registration taxes to 10% (5% for modest houses) and introduced the portability of transaction taxes, meaning that transaction taxes paid for a previous house are deducted from the transaction taxes for the next house, but only up to a maximum of € 12 500. This portability is however not transferable when moving outside Flanders. In the Brussels region, a tax exemption on the first € 45 000 (the amount is increased to € 60 000 in socially disadvantaged areas) of the acquisition price was introduced in 2003. These amounts were increased in 2006 to € 60 000 and € 75 000, respectively.

1. Imputed rentals or cadastral income is deemed to represent the net annual income (not indexed) from the premises.

20. The role of financial markets for funding mortgage lending (via mortgage-backed securities and covered bonds) remains very limited, contrary to developments in a number of countries (BIS, 2006). The market for mortgage-backed securities, which in Belgium come in the form of undertaking for collective investment in debt securities, is rather inactive and there is no legislation on covered or mortgage bonds (see below). In Belgium, mortgage lenders rely mainly on savings from private individuals for the funding of the mortgage loans. These saving flows have been quite stable as a financing source due to the tax exemption on the savings deposits (see below). The beneficial effects of using secondary market instruments are to allow access to a wider range of investor capital, increasing the ability of lenders to manage their capital and so potentially reducing the cost of mortgages, which should eventually be reflected in lower rates for the borrowers.[11]

21. Belgium is one of the few countries in the European Union that does not have a mortgage bond legislation.[12] This prevents mortgage credit institutions from funding loans through the issuance of bonds. Naturally, such issuance can take place in other countries, but that is likely to hamper the emergence of Belgian mortgage credit institutions and adds an exchange risk for foreign entrants from outside the euro area. It should be noted that one of the major advantages of mortgage credit institutions is that the interest rates for mortgages are quoted in the bond market, which increases price transparency. The emergence of specialized mortgage credit institutions would address some of the asymmetric information problems in the current bargaining process for mortgages. This would lead to borrowers paying similar interest rates regardless of income, which would provide low-income families with cheaper finance for owner-occupied housing (OECD, 2006). Thus, the introduction of mortgage bond legislation is likely to make the mortgage

11. Funding through the financial markets mostly takes the form of covered mortgage bonds and mortgage-backed securities. Both are based on trading the rights to the borrower's agreed stream of payments. Mortgage-backed securities is a funding and risk transfer technique where the bank or finance company originator of mortgage loans sells and/or transfers these loans to an independent special purpose company or vehicle in return for cash payment. A covered mortgage bond is typically a mortgage securitisation where the bank of finance company keeps the loans on its balance sheet, and the legal rights as well as the underlying loans satisfy conditions set out in a law regulating the issuance of covered bonds. As one of the few remaining countries in Europe without this kind of legislation, Belgium does not allow mortgage institutions to operate.

12. In the context of establishing a market for mortgage-backed securities, the financial institutions were asked whether the development of such a market would benefit from mortgage bond legislation. However, the institutions showed little interest as they use the special purpose vehicle of undertaking collective investment in debt securities mentioned above for securitising their outstanding mortgage loans.

market more contestable and therefore an appropriate legislation on mortgage bonds (covered bond legislation) should be introduced.

22. Another regulatory cost that may hinder the supply of mortgage credit – in particular to sub-prime borrowers – is the lengthy enforcement procedure in case of default (foreclosure costs). The usual time required for the distribution of the proceeds to creditors in Belgium is 18 months (Table 5.4). In comparison, the time required in countries with well-developed bond markets, such as Denmark, the Netherlands and the United Kingdom, is less than a year. The speed of foreclosure translates into higher costs for lenders which tend to be passed on to consumers (Mercer Oliver Wyman, 2003). Hence, high enforcement costs due to the lengthy procedure would force mortgage institutions to charge higher interest rates irrespective of their customers' risk profile, which in comparison with the well-informed banks would tend to blunt the competitiveness of mortgage institutions. This would indicate that reducing the time of mortgage enforcement procedures would level the playing field between different financial institutions.

Table 4. Mortgage enforcement costs

	Usual time required[1] (months)
Austria	6
Belgium	18
Denmark	6
Finland	3
France	15–25
Netherlands	6
Sweden	5
United Kingdom	8–12
United States	8

1. Total time from right of execution (in countries where the mortgage must be given executory power by a court) to the distribution of proceeds to creditors).

Source: OECD Economic Outlook 75; *The Economist*; Ahearne *et al.* (2005).

23. Regulation prescribes that mortgage contracts with variable interest rates must include caps and floors that limit the extent to which mortgage interest rates can vary. Such regulation may be found in other countries, but Belgium has some of the strongest legal requirements on such matters (EMF, 2006b). Rates cannot be adjusted more than once a year and consumer protection legislation requires that variable interest rates do not increase by more than 1 percentage point during the second year and by more than 2 percentage points during the third year of the contract. While such regulation protects borrowers from large shifts in interest rates, it makes the funding of mortgages more costly. Moreover, there is a cap on early repayment fees of three months' interest on the remaining amount (Table 3). This is unlikely to cover the associated refinancing cost, which is the standard (either through explicit fees or embodied in the interest rates on offer) in other European countries. An additional concern is that such specific regulation increases the cost of entry and may exacerbate structural and economic differences between markets, making integration of European financial markets more difficult (MOW, 2003). Therefore, the regulation on adjustment caps on interest rates should be phased out and caps on early repayment fees should be cost-based to allow creditors to charge an objective fee to compensate for associated losses.

Consumer credit regulation

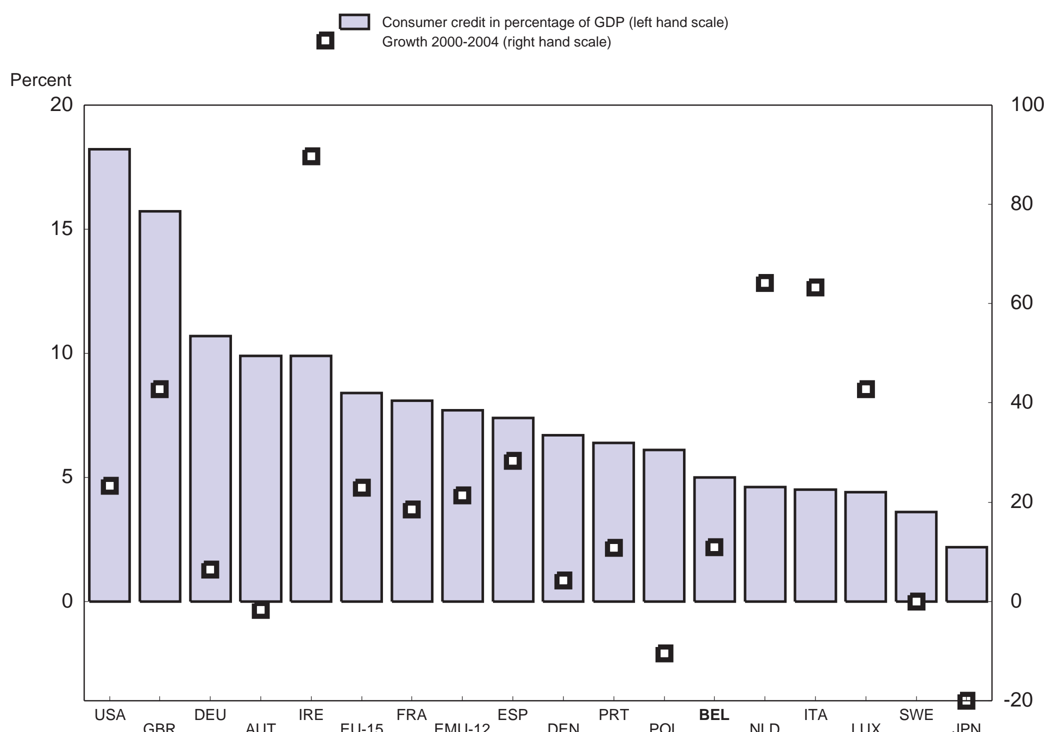
24. Consumer credit is another category of financing available to people wishing to smooth their consumption through temporary economic slowdowns, in particular cash-constrained people. It is typically

offered to consumers directly in stores and is therefore immediately available to the consumer to finance purchases. In Belgium, however, suppliers of consumer credit, including credit card issuers, are subject to strict regulation meant to protecting consumers against over-indebtedness. Credit regulation is generally meant to correct market failures arising from the asymmetry of information between lenders and borrowers. Lenders may not have enough information to price the credit in accordance to the borrower's risk profile and therefore may be inclined to err on the side of overcharging. Similarly, borrowers may not have enough information on the terms of the credit to compare different offers and fully understand the financial consequences of their decision. Most countries require full disclosure of information and retraction periods so as to level the playing field and fully inform the consumers. Belgium has a well-developed regulation for this purpose. For instance, lenders must make their offer according to certain rules that enable consumers to compare across providers, so contracts must include all credit costs and, to facilitate comparisons, these costs have to be presented in a comprehensive interest rate measure – the "Taux Annuel Effectif Global" (TAEG) – which includes the cost of the interest rate, administrative costs, commissions, etc. In the same vein, all credits must be registered in a national database (see below) that lenders need to consult to obtain information about the borrowers' indebtedness.

25. Existing regulation, however, goes beyond remedying the asymmetry of information and intervenes directly in contractual terms through the use of maximum interest rates. There exists a "grid" of maximum allowed interest rates (defined in terms of annualised percentage rate of charge, including fixed costs) which vary with the form of credit, the amount borrowed and, until the 31 January 2007, the duration of the contract. For a number of credit types (particularly for credit cards) the grid has become a norm as observed interest rates are very close to the maximum interest rates (Test Aankoop, 2006). This implies that most consumer credit institutions operating in these segments of the market have little incentive to engage in individual risk profiling, which again suggests that some of the existing borrowers pay higher than warranted rates.[13] Moreover, maximum interest rates that are set below market-clearing levels create supply shortage for credit, where the consequent rationing among borrowers reallocates credit toward those with higher incomes. Villegas (1989) finds clear evidence that in the United States low-income households residing in states with strict usury ceilings obtain significantly less consumer credit compared to low income households in states which had abolished usury ceilings. Thus, one unintended effect of the grid of maximum interest rates may be a reduction of credit available to low-income borrowers. Indeed, consumer credit in Belgium is at a relatively low level and is expanding at a more modest pace than in other countries (Figure 12). Several other countries, such as the Netherlands, Poland, Italy and France also apply a system of maximum interest rates. Except for France, all these countries are characterised by a low level of consumer credit outstanding.

13 Unlike in other European countries, lenders in Belgium may directly access part of the borrower's earnings without a court order.

Figure 12. Consumer credit in selected OECD countries



Source: European Credit Research Institute, statistical package.

26. As the system of maximum interest rates has become the norm for some types of credit, competition is limited among consumer credit providers in certain segments of the market. Moreover, the overall market for consumer credit is dominated by the major banks. Indeed, the importance of consumer credit specialists, although increasing, remains limited.[14] In addition, the strictness of consumer credit regulation enhances the role of overdraft facilities and other short-term bank credit instruments for financing consumption. As well, non-financial institutions like supermarkets and mail-order companies must have recourse to a financial institution/intermediary to offer credit.

27. In July 2006 the authorities adopted a new and more restrictive grid of maximum interest rates, which in the future the grid will vary with developments in market rates. As the grid was already norm-setting for certain types of credit, the cost to consumers of the regulation associated with protecting consumers against over-indebtedness is set to increase. This raises the question whether an alternative and more flexible model for consumer protection in this area could be to make the grid indicative of what is considered non-usury rates and to encourage lenders to become more prudent. Empirical research on the various effects of the interest rate grid could contribute to a debate among interested parties and help the government to formulate possible reforms. In France, for example, the authorities are investigating the possible reasons for the low level of consumer credit and this has resulted in a quantification of the number of people that are currently deprived from consumer credit under the current legislation (including usury

14 According to data from the Credit Registry at the National Bank of Belgium the market share of the banks (monetary financial institutions) for consumer credit excluding mortgages is around 70%. They dominate the market for instalment loans, the largest market segment, and they have market share of around 55% for credit openings (including credit cards). The consumer credit specialists have the largest market share for instalment sales.

rates), (Babeau, 2006). Obviously, a first step would be to obtain micro-level data on the financial situation of the households, comparable with, for example, the Federal Reserve Survey of Consumer Surveys.

28. Consumer protection is also a concern at the European level and such legislation is being harmonised within the European Union. However, current EU directives stipulate an approach of minimum harmonisation, which has allowed the Belgian authorities to maintain and introduce national legislation on top of EU requirements. This has resulted in consumer protection legislation that comes across as one of the strongest in the EU, notably with regard to counter the problem of over-indebtedness.

29. The policy objective of avoiding over-indebtedness arises from social concerns. However, the concept is difficult to measure. No consensus exists in the literature on how to measure over-indebtedness and the Belgian authorities often refer to the default rates registered by the Central Individual Credit Registry (CICR).[15] According to this definition in 2005 about 4.2% of the Belgians had a least one contract on which they had defaulted with an average amount of around € 4305 (NBB, 2006b).[16] Both numbers have decreased since 2002. Moreover, these numbers are likely to be an overestimation as they include unsolved commercial disputes and as credit providers have few incentives to seek compromises given the near-absence of personal bankruptcies.

30. Some of the responsibility for ensuring a competitive marketplace must be placed on the borrowers themselves, since knowledgeable, informed borrowers help foster competition in credit markets (Federal Reserve, 2006). An additional helpful tool is financial education, complementing basic consumer legislation or as a temporary measure towards a broader and deeper consumer credit market. In several OECD countries, financial education programmes have been established. For example, in the United Kingdom there is a free telephone helpline/consumer hotline service targeted to underserved and financially illiterate consumers (OECD 2005); other examples are informative websites in the United States and public education campaigns organised by the financial supervisor in Korea.

Tax concessions have shaped the financial development

31. Another government intervention that has influenced the financial system is the tax treatment of financial transactions. There are three main tax concessions affecting household financial decisions: the tax exemption of interest earned on saving accounts; the tax credit for contribution to second- and third-pillar pension schemes; and the tax deductibility of mortgage loan repayments (see Table 5).[17] International evidence has shown that relatively small fractions of the funds going into tax-advantaged savings vehicles can be considered to be "new" saving. As such, the best interpretation of the evidence is that such policies are expensive ways of encouraging savings (Attanasio *et al.*, 2004). According to the most recent data available fiscal expenditure related to favourable tax treatment of household financial transactions in Belgium were estimated to be around € 2.1 billion in 2002 (equivalent to 0.8% of GDP).[18] This is

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15. The CICR records all information relating to all consumer credits and mortgage loans by national persons as well as any payment defaults resulting from these loans.

16. This amount is less than one-third of net income after taxes of a single average production worker with no children earning 67% of average wage. Debt is recorded as in default on the criteria; that payments are more than three months overdue; or that three instalments have not been paid; or non-payment after one month in the case that a formal notice has been served.

17. In addition, investment decisions are also affected by the general absence of capital gain taxation.

18. This number includes fiscal expenditures related to savings accounts (€ 406 million), life insurance premium and mortgage capital repayments (€ 230 million), pension savings (€ 246 million), group life insurance (€ 86 million), mortgage interest payments (€ 325 million), other mortgage related expenses (€ 846 million). Source: Chambre des représentants de Belgique (2006). These estimates are calculated

estimated to reduce personal income tax annual receipts by about 6%, thus resulting in higher tax rates than otherwise. To the extent that marginal effective tax rates are increased by the generosity of the tax incentives, this may weaken overall economic performance.

Table 5. Main tax concessions on households' financial transactions

	Type of tax concession	Maximum amount exempted per year (euro)	
Saving account	Exemption from withholding tax	1 600 of interest earned, annually (3 200) [1]	
Third-pillar pension accounts[2]			
Individual life insurance	Personal income tax reduction at adjusted average rate for contributions	1920 (3 840) [1]	
Individual pension-saving funds		800 (1 600) [1]	
Mortgage loan repayments	Personal income tax reduction at marginal rate for all repayments combined[3]	First ten years	Afterwards
		2 560 (5 120) [1]	1 920 [4] (3 840) [1]

1. Amounts for co-habiting households.
2. If the time of withdrawal is stipulated as in the contract, the funds are taxed at 10%. for contributions or premiums paid after 1993. A rate for 16.5% is applied for contributions or premiums paid before 1993. In case of earlier withdrawal, contributions made before 1993 are taxed at the progressive rate; contributions made after 1993 are taxed at 33%.
3. These include interest payments, capital repayments and life insurance (*assurance du solde*) premiums.
4. Concessions for individual life insurance and mortgage loan repayments cannot be combined.

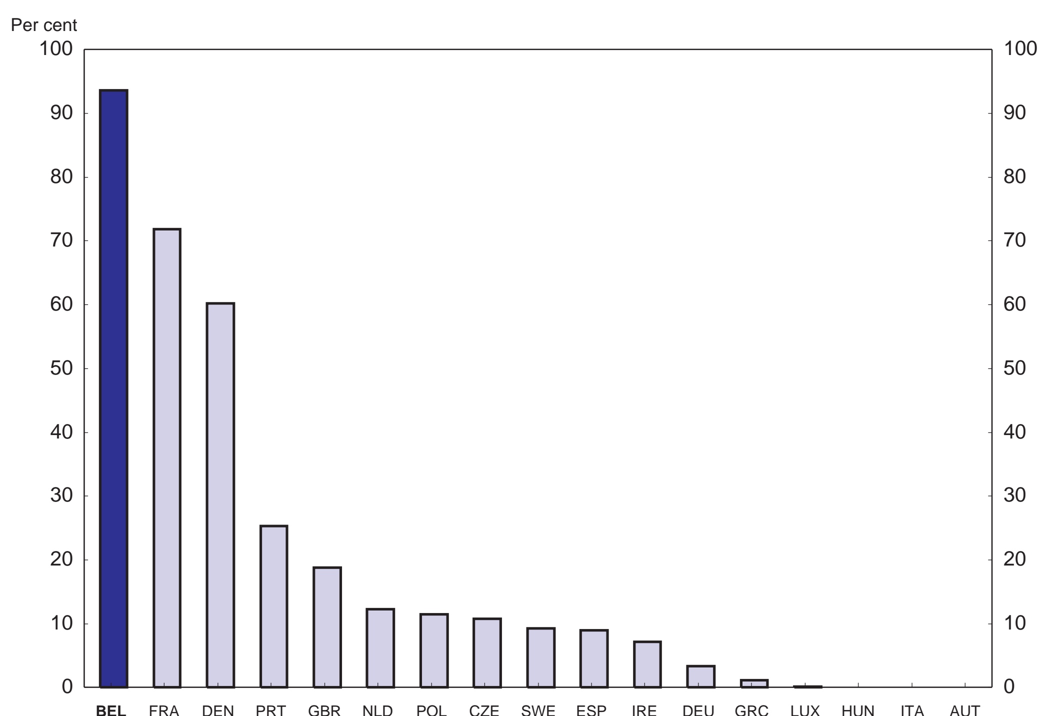
Source: Ministry of Finance, Fiscal Memento.

32. The tax concession on interest income earned in savings accounts is a long-established tradition. Savings accounts held by residents are exempt from withholding tax and from income tax up to a limit of earned interest of € 1 600 interest per year.[19] The tax concession appears to be very popular as can be gauged by the high number of saving accounts (around 17 million), which largely exceeds the Belgian population (10.4 million). This suggests a widespread practice of having multiple accounts, perhaps reflecting active consumers. On the other hand, account holders can evade withholding taxes by opening savings accounts in several banks. Currently more than € 160 billion (equivalent to about 54% of GDP) have been put into saving accounts. Preferential tax treatment of deposits and savings accounts does exist in other EU countries, but the importance of such accounts is much higher in Belgium than in other countries (Figure 13).

using the "revenue foregone" method, which is a static *ex post* calculation that is widely used because of the relative ease of computation.

19. The exemption is conditional on the requirement of a tiered remuneration structure, consisting of a base rate and premia, whereby the limits for the base rate and the various premia are set at 4% and 2%, respectively. The non-cumulative premia consist of an accrual premium and a loyalty premium, the former applying to new inflows into savings books that remain on the account for at least 12 months, and the latter applying to outstanding savings account balances that remain on the account for at least 12 months.

Figure 13. Savings accounts with tax preferences
Share of saving accounts with fiscal advantages in per cent of total, 2005



Source: European Commission, "Retail Banking Survey", 2005-2006.

33. The tax concession on the savings accounts does not appear to have an obvious policy objective. Nevertheless, it is often cited that the tax concession was introduced out of social concerns as these accounts are supposed to be the main savings instrument of the less well-off households. However, the savings accounts provide a tax-free income proportional to the deposited amounts and therefore run the risk of benefiting well-off households and hampering the income distribution ambition of the tax system. In any case the tax concession has facilitated mobilising a large volume of household savings in order to finance the public sector's past heavy borrowing requirements as well as the demands of other borrowers. Covering these heavy borrowing needs at affordable interest rates was more demanding before the creation of the euro area, as foreign investors were expecting a premium over benchmark bonds to cover the exchange rate risk.[20] The small depth of the domestic capital market also made it difficult to cover financing needs via market-based issuances.

34. In addition, there is evidence that the benefits of the tax exemption have not been entirely captured by the savers; according to Valenduc (2003), the (net) rate of return on taxable deposits has been higher than that on tax-free savings accounts with a similar investment horizon.[21] The author also

20. The spread paid by Belgian bonds above German Bunds was about 80 basis points during 1991–94.

21. Valenduc (2003) compares the rate of return and the effective taxation rate of tax-preferred saving accounts and a one-year bank deposit (subject to tax). The tax exemption does not mean that effective taxation is zero. The author computes a quasi-taxation that results from the regulation of interest rates. While the funds are readily available to the investor wishing to withdraw them, the choice of the one-year bank deposit as an alternative investment is justified given the "dormant" character of most saving accounts. Although there might be a bias in these calculations as a one-year bank deposit does not provide the holder with the same liquidity as a tax-preferred saving account.

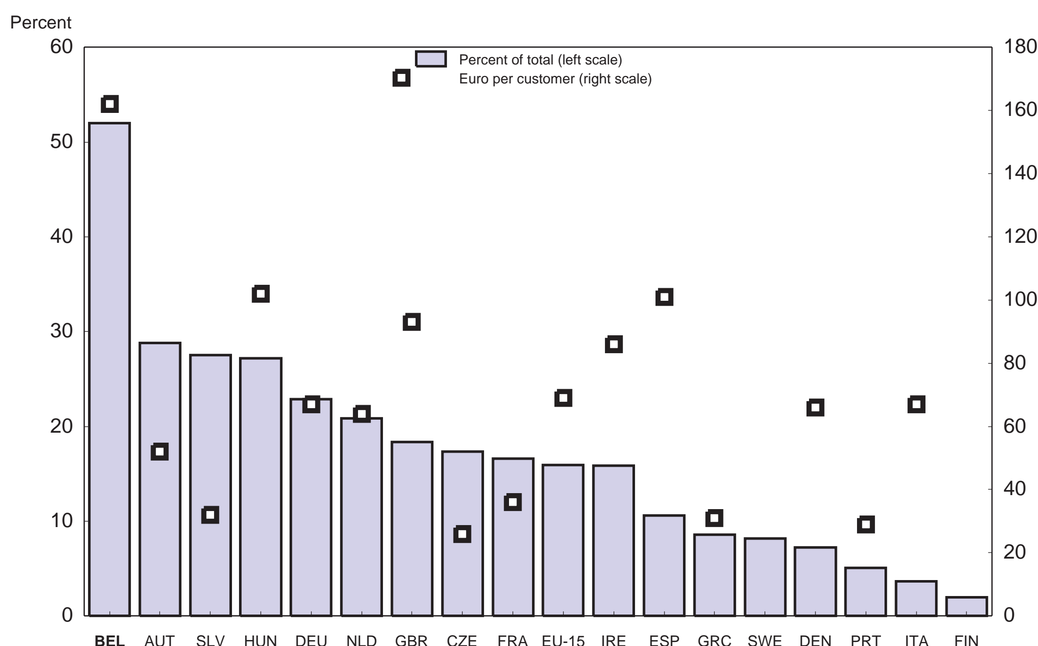
calculates effective tax rates for both products and finds that the (quasi-)effective tax rate on savings accounts is even at times higher than the effective tax rate on the non-exempted deposit, implying that the withholding tax exemption does not benefit the saver. On this evidence, the tax exemption appears to have worked, at least partially as a tax subsidy to the banking sector. It is therefore not surprising that the savings accounts have become a major source of income for the banks, as they represent half of the gross income from retail banking activity and are in terms of income per customer among the highest in the European Union (Figure 14).[22,23] A contributing factor to the latter finding is that saving deposit interest rates are rather sticky compared to changes in market rates in an asymmetric manner, with deposit rates reacting sluggishly towards higher market rates, but rapidly to lower market rates (Maes and Timmermans, 2005). At the same time, the authors find that holdings in savings accounts have limited sensitivity to rate changes in alternative instruments or to higher interest rates on saving accounts offered by niche-players. This limited sensitivity may be related to relationship banking, reinforcing the impression of major banks having a degree of market power. In 2002 (the last year for which official data is available), the associated tax expenditures were only about € 0.4 billion, reflecting current low interest rates. Given the poor targeting of this measure and that resistance to abolishing the measure is likely to be relatively limited at current rates, this would seem to be an opportune moment to reconsider this tax concession. A removal of the incentives to invest in the savings accounts could in the short-run have consequences for banks and potentially the overall financial stability (the share of savings deposits represents over 15% of banks' liabilites). However, there is currently a mismatch between the maturity of the banks' assets and liabilities as short-term demand deposits are financing long-term loans, including mortgages. Thus, the present system is already posing challenges for the banks' risk management (Dewachter, Lyrio, Maes, 2006). An additional measure is that the authorities should take steps towards establishing information gathering to ensure that the holding of multiple accounts does not lead to tax evasion.

35. Another tax incentive has been offered to encourage individual investment in second- and third-pillar pension schemes, so as to complement the low replacement rate in the first-pillar pension scheme. In response to ageing, households are increasingly focusing on longer term savings through individual and group life insurance and pension-saving funds, but this trend has been reinforced by the favourable tax treatment of pension products. In the case of pension-savings funds, the investment is deductible from households' taxable income up to a certain ceiling. Although it is not generous, by international comparison this tax concession nonetheless distorts the composition of household saving (Yoo and de Serres, 2004). The taxation of savings should become more neutral not only *vis-à-vis* products within the same area, but also across product areas. A guiding principle in this area might be the EU rule for withholding tax on cross-border deposits. This could be applied to domestic savings accounts and introduce the same rate to all financial instruments.

22. The highest income per customer for deposit and saving accounts is actually reported for Luxembourg and Cyprus, but for confidentiality reasons the figures for these countries could not be given (EC, 2006).

23. The variable gross income captures all revenue that banks make on banking activity, covering interest and non-interest sources. Clearly not all gross income is paid directly from consumers to banks. A saver earning a rate of interest may receive interest payments from their bank while the bank uses the saver's capital to earn higher returns elsewhere (EC, 2006).

Figure 14. Gross income from retail banking activity for deposits and savings[1]



1. Retail banking activity includes current accounts, deposits and savings, consumer loans, mortgages and credit cards. The variable gross income captures all revenue that banks make on a specific retail banking activity, covering interest and non-interest sources.

Source: European Commission, "Retail Banking Survey", 2005-2006.

36. The third tax provision that shapes households' financial decisions is the deductibility of mortgage loan repayments. This tax provision was introduced to support home ownership and improve the quality of housing. Even though these goals appear to have been achieved – as judged by the high level of home ownership by international standards – the maximum permissible amount of tax deduction was nevertheless increased in 2005, unlike the trend observed in other countries (Box 4). Under the new fiscal regime, tax deductibility is applied to all mortgage expenses, which include interest payments, capital repayments and life insurance premiums. The new legislation introduces a fixed amount (indexed to price developments) of what can be deducted from the borrower's taxable income at his or her marginal tax rate.[24] Moreover, these amounts are doubled for co-habiting households. Empirical studies suggest that the tax deductibility may have been internalised, at least partially, into higher house prices, although the complexity of the various tax incentives make such results subject to caution (IMF, 2006). The optimal taxation of housing is based on the neutrality criterion. This implies that housing should be taxed the same way as alternative investments (Van den Noord & Heady, 2001). As it is the case for taxation for investments, tax issues for housing arise at three levels: the acquisition of the house (which is equivalent to a financial investment), the imputed rent and capital gains (equivalent to the return on investment) and the liquidation of the invested capital when the house is sold. Tax neutrality is reached when the three levels

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24. The European Commission has sent Belgium a formal request to amend its legislation concerning tax relief for owner-occupied houses. A person resident in another Member State and owning a dwelling with a mortgage there and obtaining his income entirely or almost exclusively from work performed in Belgium will thus not be able to benefit from the tax relief related to his mortgage loan in the same way as a person resident in Belgium. According to the European Commission, this constitutes an infringement of the free movement of workers.

are treated in a symmetric manner. This is the case when either a taxed-taxed-exempt (TTE) or an exempt-taxed-taxed (ETT) scheme is applied to the three levels and comparable tax rates are used. Currently, imputed rentals are below comparable private market values and realised capital gains are not taxed after a holding period of five years (Carey, 2003). This implies that Belgium is close to applying a TEE tax schedule. In such circumstances, an additional favourable tax treatment on mortgage loans favours the allocation of capital towards owner-occupied housing at the expense of possibly more productive uses. Against the background of the already high degree of owner-occupied housing and the possible distorting effects of the tax provision on deductibility of mortgage loan repayments, the tax subsidy scheme should be reduced in scope and, at the least, be restricted to the interest component.

Box 4. Tax subsidies for households with mortgage loans

In the following countries a reduction in tax deductibility of mortgage loan repayments has been implemented:

- Sweden reduced the tax deductibility of mortgage interest payments over a period of time (1985–1991). The maximum deductible rate declined from 50% in 1985 to 30% in 1991.
- The United Kingdom fully phased out the tax deductibility of mortgage interest payments over the course of 25 years (1974–1999). First, a nominal ceiling was introduced on the size of mortgages eligible for interest deductibility. Second, the tax rate at which interest on debt below the ceiling could be deducted was gradually lowered to zero.
- In Denmark, the tax value of interest deductibility was reduced in several steps during the 1980s and 1990s. As the marginal tax rates for capital income were reduced from 46% to 33%, this reduces the tax value of deductible interest payments.
- In the Netherlands several steps have been taken to limit mortgage interest deductibility when owner-occupiers withdraw housing equity: since 1997, they have not been permitted to claim interest deductions on equity withdrawals from their existing residence except for home improvements; since 2001, the period during which mortgage interest payments could be deducted from personal income has been limited to 30 years and, more importantly, a cut in tax rates has effectively lowered tax subsidies for high income earners by about 20%; and, from the beginning of 2004, owner occupiers can only deduct interest on that part of the mortgage that is equal to the home's value minus the equity withdrawal from the former home (OECD, 2004).
- In France, the tax credit equal to 25% of mortgage interest payments, conditional on being the principal residence and only for the first five years after the purchase, was abolished in 1997.

Conclusion

37. The Belgian financial system is generally sound and has been supportive of economic activity. Indeed, the sector does not appear to be in need of major reforms. Nevertheless, it would appear that the interaction of a highly concentrated retail banking sector, tax policies and consumer protection legislation have reduced competition. To rectify the situation, there is a need to make tax policies more neutral across financial instruments and rebalance consumer protection legislation towards enhancing competition. Moreover, the current dominance of the four largest banks suggests that additional competitive pressures are most likely to arise from further market entry. To facilitate the latter, the authorities should limit national regulation and support the implementation of EU directives on the creation of a single internal financial market. In addition to these broad recommendations, the set of detailed policy recommendations is summarised in Box 5.

Box 5. Policy recommendations to enhance the benefits from financial liberalisation

Measures favouring the cross-selling of products by *bancassurance* conglomerates

- The explicit regulation allowing tying of a mortgage interest rate reduction and the purchase of certain insurance products should be abolished to stimulate price transparency and thus increasing competitive pressures.
- More generally, to further strengthening competition and contestability in the financial market, the competition authorities should assess if current cross-selling practices are in line with the common set. of competition principles across the economy.

Measures to facilitate households' access to credit

- Modernise home equity withdrawal legislation to allow consumption smoothing for households, facilitate pension financing and enable intergenerational transfers of capital gains.
- Further reduce the real estate transactions costs to stimulate the market for mortgages.
- To deepen mortgage loan markets, appropriate legislation on mortgage bonds (covered bond legislation) should be introduced.
- The lengthy foreclosure period of non-performing loans should be lowered to comparable levels in other countries.
- Caps on early repayment fees should be cost-based to allow creditors to charge a fair and objective fee to compensate the loss.
- Regulation of adjustment caps on interest rates should be phased out and left to individual decisions.
- Stimulate thorough empirical research on the various effect of the interest rate grid on consumer credit, including evaluations of such measures as making the grid of maximum interest rates indicative of what is considered non-usury rates to contribute to a debate among interested parties and to help the government to formulate possible reforms.
- Enhance competition by promoting the principle of "full harmonisation" of the EU consumer credit directive with a minimum of national legislation on top of EU requirements.
- The authorities should focus more on consumer information and financial literacy through financial education programmes as knowledgeable informed borrowers help to foster competition, in particular in transition to a broader and deeper financial market.

Tax treatment of households' financial transactions

- Tax rules should be more neutral to decrease distortions in the allocation of savings. In particular, given the poor targeting of the tax exemption on savings accounts, this measure should be reconsidered. It would be preferable to introduce the same tax rate for domestic savings accounts as those applied to intra–EU cross-border deposits.
- Tax deductibility granted to mortgage loans should be re-evaluated against its original goal of home ownership and should at least be restricted to the interest component.

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