

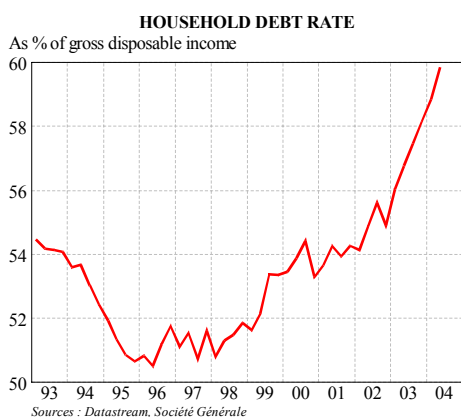
## THE CONSEQUENCES OF GROWING MORTGAGE DEBT

- Household debt has become a much heavier burden, rising from 56 % of disposable income in early 2000 to nearly 60 % by mid-2004. This trend, which has been accelerating since spring 2003, is mainly due to growth in mortgage loans (almost 70 % of new credit), itself driven by the strength of the property market (more transactions and higher prices).
- Apart from the Robien tax incentive to buy new homes since April 2003, the improvement in household solvency has been behind the increase in mortgage debt despite the surge in house prices. The steady fall in the cost of borrowing and the extension of credit duration have made this possible. However, mortgage debt is likely to slow considerably in 2005, although a soft landing for the housing market currently seems the most likely scenario.
- The boom in household and mortgage debt has made a huge contribution to the pleasant surprises for French consumer demand since the end of 2003: the construction sector is being driven by demand for new homes – a trend that is likely to continue over the next few quarters - and households are withdrawing part of their capital gains made on property when carrying out transactions on old homes, thus feeding consumer spending (particularly on durable goods).
- The risk attached to these booms is that of a hike in interest rates. However, this risk is limited by the very high proportion of fixed-rate loans. There is no significant threat for lending institutions.

### Accelerated growth in household debt, buoyant property market

#### Household debt is still accelerating in 2004

After two years of sustained growth, household debt accelerated in the first half of 2004: household debt to financial institutions was up 9.5 % yoy in July, from an already impressive rate of 7.1 % in the year to December 2003. Outstanding credit reached EUR 623bn in July. The household debt rate (outstanding debt/gross disposable income) rose from 56 % at the beginning of 2003 to a record 59.9 % in June 2004.

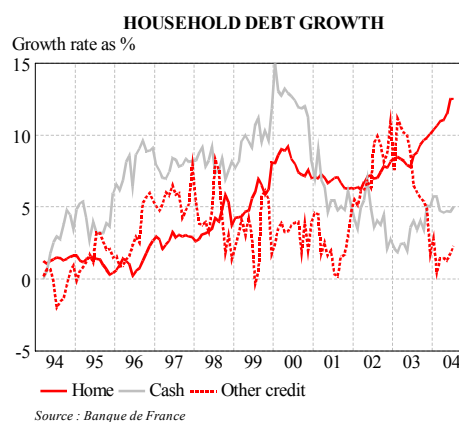


Even more illustrative is the fact that household debt flows were up to EUR 26.5bn over the first six months of 2004, compared with EUR 16.6bn over the equivalent period of 2003.

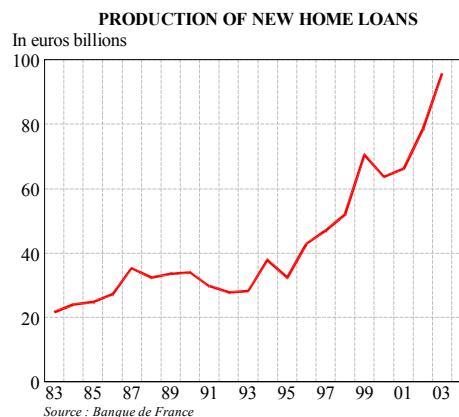
#### Rise in home loans

The increase in debt is primarily due to very robust growth in home loans, especially since the spring of 2003: these were up 12.5 % yoy in July 2004, compared with an 8.6 % rise in the year to July 2003. Mortgage credit has been growing more rapidly than other types of consumer credit since 1999.

Total outstanding home loans stood at EUR 414.9bn in July, reaching 67 % of outstanding consumer credit and 39 % of gross disposable income (GDI).



Growth in outstanding credit reflects very high production thereof.



Growth in new home loan flows came out at 22 % in 2003, i.e. EUR 95bn (versus nearly EUR 30bn in the mid-1990s). The first two quarters of 2004 saw this trend intensify with new credit flows already up EUR 53bn after just six months.

The volume of new loans has now reached an all-time high after eight years of increases since 1996 (a dip was noted in 2000, though, the after-effect of the 1999 boom linked to the end of the Périssol amortisation measures). Growth in outstanding corresponding to these productions is limited by the fact that many loans taken out in the 1980s are now reaching maturity, hence the high amounts of capital repayment. In addition, the rise in transactions on old buildings has resulted in substantial redemptions (new credit production for old homes concerns 65 % of the total, compared with 55 % in 1993).

Loans from the competitive sector account for a higher proportion of these new loans than they did 10 years ago: whereas regulated and subsidised credit flows have risen at the same pace (new regulated loans amounted to approximately EUR 21bn in 2003, compared with EUR 18bn ten years earlier), subsidised credit flows have increased sevenfold, from EUR 10bn in 1993 to EUR 75bn in 2003. Altogether, 70 % of outstanding investor credit (households and legal entities) is now unassisted, compared with 33 % in 1993.

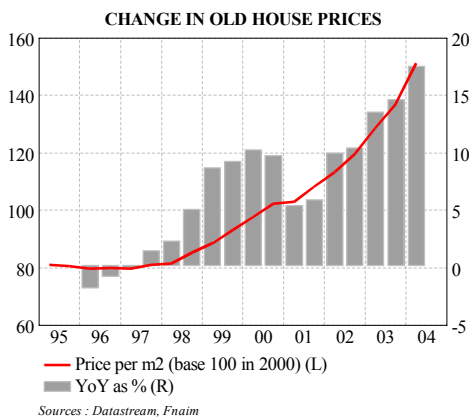
LOANS ISSUED TO RESIDENT UNITS  
BY CREDIT INSTITUTIONS: BREAKDOWN BY TYPE

	Dec 1999	Dec 2000	Dec 2001	Dec 2002	Dec 2003	Mar 2004
HOME	382.4	407.2	430.0	457.5	500.6	511.8
INVESTOR CREDIT	376.4	400.6	423.4	450.6	493.2	504.4
OF WHICH SUBSIDISED AND REGULATED LOANS	169.6	168.3	168.5	166.7	166.7	166.5
PROMOTER CREDIT	6.0	6.6	6.7	6.9	7.4	7.4

In light of the Bank of France's Q2 survey of financial institutions, demand for home loans is likely to continue rising.

#### • The strength of the housing market

Growth in mortgage credit has accelerated despite – or because of – rocketing house prices in recent years. According to the FNAIM, property inflation for old homes was up from 14.5 % yoy in H2 03 to 15.4 % yoy in H1 04 (+46.9 % in three years, +86.9 % in six years).



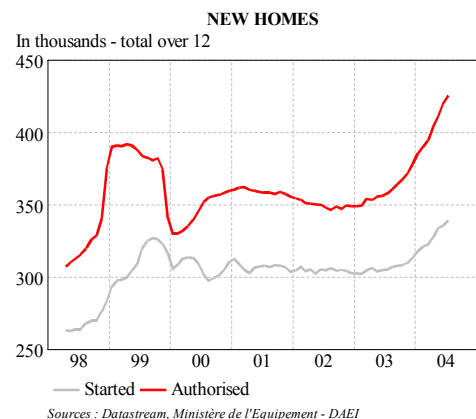
According to Ministry of Equipment data on new homes, apartment prices were up 8 % yoy in Q2 04 while detached house prices were up 11 %.

The rise in outstanding home loans is currently driven by house-price inflation rather than an increase in the number of loans

issued. The first-time buyer mortgage holding rate has been stable: according to the Household Debt Observatory, 28.5 % of all households held a mortgage in 2003, compared with 29 % in 1999 and 33.7 % in 1990<sup>1</sup>.

Since the spring of 2003, the market for new homes has shown fresh signs of life, while the number of transactions on old homes remains high, even though it is easing:

- The number of building permits is now peaking after experiencing an incredible burst of pace since the spring of 2003: the three-month moving average now stands at 23 % yoy, compared with 10 % in January. Housing starts have followed a similar trend, albeit with a slight delay; up 15.1 % yoy in July compared with 13 % in January. New house sales also accelerated in the second quarter (+16 % on Q2 03), largely due to a 20 % increase in availability. The residential construction sector is reaping the full benefits of the Robien tax incentive<sup>2</sup>, introduced in April 2003, which has made rental investment highly attractive: of the 103,201 new homes sold in 2003, more than 50 % were related to the Robien law. According to the residential construction survey, buy-to-rent demand is still rising.



- Activity in the residential construction sector is likely to remain buoyant. According to INSEE's building survey for July, personal business prospects remain bright and entrepreneurs do not foresee any notable imminent change in the economy (the books already contain enough orders to ensure 5.8 months of full-time employment).

The number of house building permits issued each month has been stabilising recently and is likely to level off at between 425,000 and 450,000 in 2004 – close to the levels reached over the past 12 months. In contrast, housing starts should continue to rise over the next few quarters given the usual time delay between receiving authorisation and starting work.

Transactions on old homes remain high<sup>3</sup> although there has been a slight dip on 2003 levels. This follows several years of almost non-stop growth. The number of transactions was down 2.1 % in 2003, the first decline in seven years. This reversal of trend was confirmed in the first half of 2004: -1.9 % in Q2 after -0.9 % in Q1.

<sup>1</sup> Household Debt Observatory figures were taken from the 2003 annual survey.

<sup>2</sup> Investors must lease this property for nine years but can subtract a significant percentage of the purchase price from taxable income (8% per year for 5 years, then 2.5% for another 10 years). Renters no longer have to fall below a particular level of income and rent ceilings have been raised considerably (nearly 40%) on their "Besson" levels. They are now close to market rents.

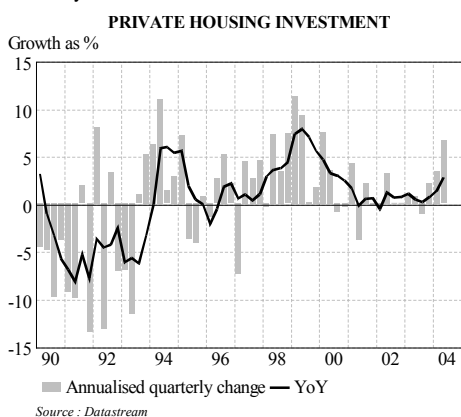
<sup>3</sup> According to the FNAIM indicator, apartment activity virtually stagnated between 2000 and 2003 while house transactions rose sharply.

- **The impact of the ascending property market and rise in mortgage debt on the economy**

There are two ways in which these have a positive impact on the economy:

*Directly:*

- With new homes, the recent burst of construction has an impact on demand and activity, via the housing component of GFCF: the volume of housing GFCF was up 6.8 % yoy in Q2 04, after a 3.4 % yoy increase in Q1 (average annual increase of 0.7 % in 2002 and 2003). If we base our forecasts on the rise in housing starts, this component of demand (4.6 % of GDP) should continue to climb into early 2005;



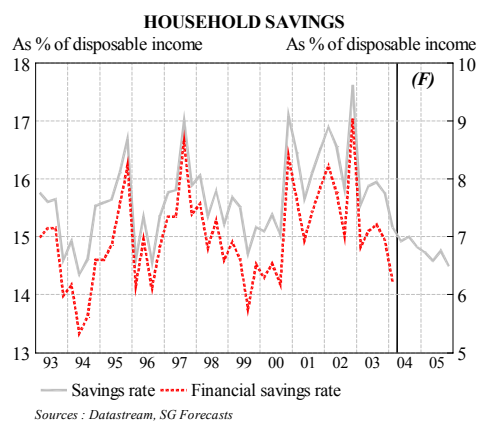
- With old homes, some households are withdrawing some or all of their capital gains (some of the funds thus collected then being used to buy another place), pushing up the amount of outstanding loans (new credit exceeds redemptions). This injection of liquidity into the economic circuit stimulates consumer spending, particularly on capital goods.

If households are aware of the capital gains on their property and consider themselves richer, they may choose to spend more, either by saving less or by taking out a loan (outstanding current account loans has been growing by nearly 5 % yoy since the summer of 2003, compared with around 2 % at the end of 2002).

In France, the wealth effect will doubtless primarily concern the old property market and the sale of land: it is now that households are withdrawing their capital gains. This effect is therefore less significant and less rapid than in countries where households can obtain a loan secured again a property asset to make a purchase or invest in something other than property (i.e. a mortgage equity withdrawal)<sup>4</sup>. Furthermore, mortgage refinancing is possible in some countries such as the United States.

However, the rise in mortgage debt seems to be one of the major causes behind the drop in the household savings rate. The sharp increase in debt flows between H1 03 and H1 04 (EUR 9.8bn, i.e. nearly two disposable revenue percentage points over six months) has been accompanied by a significant drop in the financial savings rate (ratio between financing capacity and gross disposable income). This stood at 6.2 % in early 2004, down from an average of 7 % in 2003. The household savings rate, for its part, fell from an average of 15.8 % in 2003 to 15.1 % in Q1 04. The offshoot of this reduction in the savings rate is that consumer spending held up well over the period (up 3.6 % yoy in Q1 and 2.9 % yoy in Q2).

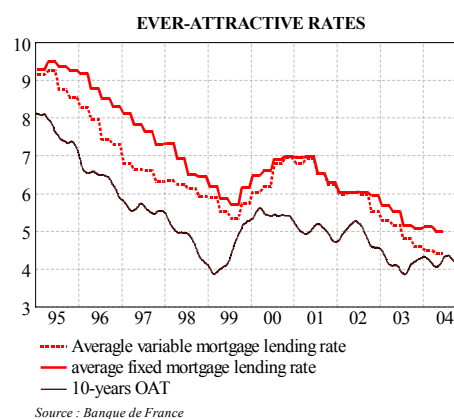
<sup>4</sup> This is the case in the United States, United Kingdom, Australia, Netherlands and some Scandinavian countries.



**Causes of growth in mortgage debt: historically low interest rates and the extension of loan repayment periods have improved household solvency**

- **Attractive cost of borrowing...**

Ignoring the initial success of the Robien tax incentives, the low remuneration on regulated savings and poor stock market, the main reason behind the sharp increase in mortgage debt since the spring of 2003 is the attractive cost of mortgage borrowing, which has hit the floor in nominal terms.



The prolonged fall in short-term interest rates, the climate of low inflation and, for the moment, an increase in risk aversion, have brought bond yields to historically low levels, hence the particularly low average fixed mortgage lending rate (for all networks): 5 % in June 2004 versus 5.5 % year earlier. Variable interest rates, which apply to a little under 20 % of the credit supply and are generally capped, have shed 80bp in the space of one year to stand at an average of 4.4 % in June.

- **...and advances in financial technology...**

Against a highly competitive backdrop, lending institutions have been forced to reduce their margins (the difference between the average fixed mortgage lending rate and 10-year OAT yields fell from 150pts in January 2003 to 60pts in June 2004) and have broadened their range of offers, mainly by extending maturities. According to the Household Debt Observatory, the average mortgage term is now around 15 years, compared with 11.1 in 1992, while the proportion of long-term loans (20-25 years) is substantial, now that cheaper borrowing has made them more attractive.

- **...have improved household solvency**

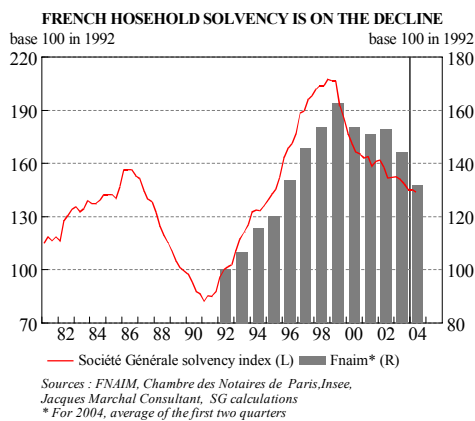
Longer mortgages and lower interest rates have directly improved household solvency. For a given effort ratio (monthly repayment/income), households' borrowing capacity has increased considerably, enabling a larger number of people to buy their own homes: liquidity requirements have been eased significantly.

The Household Debt Observatory estimates that household solvency improved by around 50 % between 1993 and 2003 (the decline in employment since 2001 and the rapid rise in house prices from 1999 have obviously limited the improvement, which would otherwise have been 65 %. The extension to loan duration alone explains a third of this improvement, the drop in interest rates the other two thirds.

- **Dip in household solvency at the end of the period**

Household solvency is now on a downward trend, and this movement is accelerating at the end of the period due to the sharp rise in house prices. This situation looks set to continue: weak income growth in 2004 and, to a lesser extent 2005 – mainly due to the slackness of the labour market – and the probable rise in market interest rates and therefore the cost of borrowing (even though the adjustment delay between the average fixed mortgage rate and OAT yields is long, averaging around six months), will affect household solvency: the great unknown is inflation.

The FNAIM solvency indicator, which takes four factors into account (change in household income, loan repayment conditions, government incentives to first-time buyers and changes in house prices), has been falling since early 2003 and had lost over 11 % yoy by mid-2004 (more than 20 % over the past five years, admittedly from a high starting point). It is now back to its 1996 level.



To analyse a longer period, a simplified solvency indicator based on existing property in Paris was drawn up using Chamber of Notaries data<sup>5</sup>. We have assumed mortgages are for 15 years at a fixed interest rate. This indicator is almost back to its 1985-86 and 1995 levels, although these levels still seem acceptable.

<sup>5</sup> In the first instance, we need to calculate the amount that can be borrowed, in relation to the cost of credit and disposable income (the personal contribution rate is supposed to be constant, as is the average duration at 15 years in this case). Secondly, we need to calculate the surface area that can be bought with this amount, taking into account changes in existing house prices in Paris.

Working on the simplified assumption of a stable average loan duration over the period (15 years), stress tests reveal the change in solvency indicators under different price and interest rate circumstances between now and mid-2005 (assuming the net average wage rises 2.5 % per year).

YEAR-ON-YEAR CHANGE IN THE SOLVENCY INDICATOR				
Cost of credit	+0bp	+50bp	+100bp	+150bp
<b>House prices</b>				
-5 %	7.9	4.9	2.0	-0.8
+0 %	2.5	-0.4	-3.1	-5.8
+5 %	-2.4	-5.1	-7.8	-10.3
+10 %	-6.8	-9.4	-11.9	-14.4
+15 %	-10.9	-13.4	-15.8	-18.1

If annual house-price inflation rises back to 15 % and the cost of credit gains another 1.5pts, the decline in the FNAIM solvency index would be particularly violent as we would find ourselves in the same situation as in 1993. This would be unsustainable and would probably lead to a brief breakdown in the market, followed by a downward correction to prices.

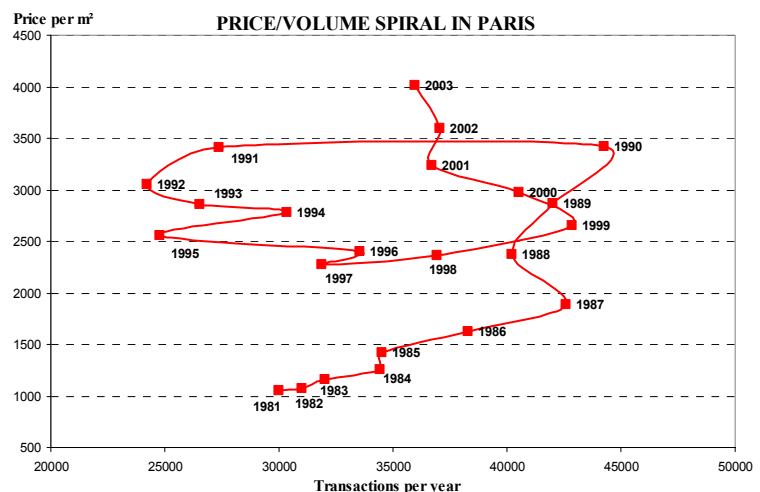
For long rates to rise by around 50bp-100bp – our central scenario – prices would have to stagnate to stop the rot for the solvency index and keep it in a range that might be considered sustainable. A 10 % increase in prices would cause a deterioration at the same speed as over the past year and would put the household solvency indicator in a position that could not be sustained in the long term.

### The risks attached to a rise in mortgage debt

- **The most likely scenario: a soft landing for the property market**

The rise in house prices makes us wonder whether there is a property bubble and if this might eventually burst.

One reassuring point is that, until now, speculative behaviour seems to have been infrequent. For example, a look at prices and transactions on the existing market in Paris over the long term (data on the national existing market over the long term being unavailable) reveals a fairly modest level of transactions (1999-2000 were affected by the end of the "Périssol amortisation" measures).



Since 2001, we have been particularly far from the very high levels of transactions of 1989/90. As far as prices are concerned, the chart above highlights how substantial a transaction trend must be to trigger a significant change in prices (fall between 1991 and 1997, increase thereafter). However, by mid-2004, the number of transactions on existing homes had edged downwards at most.

For there to be a violent correction to prices, demand would have to collapse and supply would have to increase. However, this risk is limited if our macroeconomic scenario is correct.

Economic and structural reasons explain why demand has remained high: acceleration in rents and, for the moment, the relative lack of homes in the rental sector; households' fears about pension funding; risk aversion weighing on the stock market; and potentially high demand for housing (demography, sociological changes, population movements). Actual demand will, however, be limited by the deterioration to household solvency. To this end, there are two conflicting scenarios: that of a sharp increase in long-term interest rates, in the event that world growth proves more robust than expected and significant inflationary pressure arises; or, a double dip in the economy prompts a surge in unemployment, which a further reduction in long rates would be unlikely to offset, due to the low starting point.

At the same time, supply-side indicators reflect a certain degree of tension, at least for new homes. The number of homes being put on the market has risen more quickly than sales in recent months; stocks of new homes available for sale have continued to decline with the average time it would take for stocks to disappear dropping below four months (versus seven months in 2002) – an all-time low.

All things considered, our central economic and interest rate scenario is consistent with a soft landing for the property sector, as long as speculative behaviour does not start up again, as it did at the end of the 1990s.

• **In terms of financial stability, the impact of a rate hike would be limited by the small proportion of variable rate loans**

Although the debt burden has become heavier, the level of interest rates is making it supportable for the time being: the interest charge on debt accounts for a historically low proportion of household income, less than 3.5 % of GDI. However, we note a slight decline in the situation for households, mainly those who have built up cash and home loans. According to the Household Debt Observatory's "Household debt at the end of 2003" survey, 65.9 % of households whose only debt is a mortgage consider the weight of their repayment charges to be satisfactory, well above the 57.7 % in 1990. For households with outstanding home and cash loans, this proportion falls to 45.9 % (38.1 % in 1990).

In France, the risk attached to the rise in interest rates is naturally limited by the fact that the percentage of variable rate mortgages remains low, even though it is trending upwards (25 % of loans taken out in 2003 were variable rate, compared with 20 % in 2000, although these rates are usually capped). As a result, rate hikes only affect new loans.

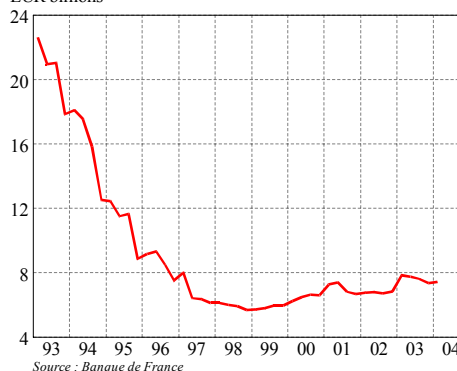
There has been no increase in the number of high-risk borrower profiles. In fact, credit institutions are still being demanding in issuing loans (the debt ratio – debt servicing/income – is still around 30 % while the sustainability of income remains an essential criterion). Apart from the extension in loan duration, we have, however, noted an increasing proportion of loans for which the personal contribution is less than 10 % and sometimes even nothing. The success of the Robien law explains some of this development, though, as borrowing becomes more appropriate than spending due to the fact that mortgage interest can be deducted from rental payments when paying taxes.

Guarantees on the property being financed limits the risk even further<sup>6</sup>. Home loans to individuals are mostly secured (the only major risk being the devaluation of these property assets). Also, although it is not a legal obligation, credit institutions are still demanding death-invalidity-incapacity insurance; unemployment and redundancy insurance are optional but are very often required.

As a result, the overall risk of households defaulting remains low: Non-performing consumer loans (including cash and other loans) accounted for just 4.1 % of total credit in Q1 04 compared with an average of 7 % in 1993. They now stand at EUR 24bn, which is more or less the same as at the beginning of the 1990s.

Furthermore, outstanding home loans for promoters (loans aimed at promoting office space or dwellings), amounted to just EUR 7.4bn in Q1 04, i.e. only 1.5 % of all home loans issued (households and legal entities), compared with nearly EUR 23bn in 1993. Credit institutions' exposure is much lower than during the last property bubble<sup>7</sup>. The risk is all the more limited by the fact that promoters' housing activity is currently notable for a lack of stocks and a high level of demand.

**CREDIT ESTABLISHMENTS' LOANS TO PROMOTERS**  
EUR billions



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<sup>6</sup> There are three types of guarantee on the property: mortgage, a preferential loan and guarantee from a third party or specialist establishment.

<sup>7</sup> We do, however, need to distinguish between outstanding loans which are utilised and booked on banks' balance sheets and confirmed outstanding loans which are still more significant than credit institutions' exposure. The credit line utilisation rate is relatively low in periods of strong economy, as is the case today, as rapid sale of homes limits the need to borrow. The utilisation rate of credit opened by promoters is currently around 50%, compared with 100%-110% during the property crisis of the early 1990s.

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