



ECFIN *Country Focus*

ECONOMIC ANALYSIS FROM EUROPEAN COMMISSION'S DIRECTORATE-GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

HIGHLIGHTS IN THIS ISSUE:

- *The financial sector accounts for a quarter of GDP.*
- *Luxembourg has the world's second biggest fund administration industry.*
- *Foreign banks dominate the Luxembourg financial centre.*
- *Most private deposits are collected from non-residents households and large companies who concentrate their treasury operations in Luxembourg.*

Luxembourg's financial centre and its deposits

By Markus Wintersteller*

Summary

AAA-rated Luxembourg hosts the biggest banking sector in the European Union if measured in percent of GDP and attracts a lot of non-resident deposits. Banking activity accounts for a quarter of GDP. With EUR 2.4 trillion under management, the country's fund administration industry is the second largest worldwide. Although the banking system's total balance sheet is more than 18 times the size of the economy, domestic banks account for only 1.5 times GDP, a rather low share in a European comparison. Luxembourg's banks display healthy financial soundness ratios, are well capitalised and are not excessively leveraged. Most foreign banks play a marginal role in financing the economy as only a handful provides retail services, while the large size of individual deposits reduces the contingent liabilities for the domestic economy. When the Luxembourg-based subsidiaries of the failed Icelandic banks were hit, the national deposit protection scheme stepped in effectively.

Introduction

The events in Cyprus have drawn attention to small countries with relatively large banking sectors. This Country Focus argues that Luxembourg does not resemble Cyprus in 2013, nor Ireland or Iceland in 2008. As asset growth was moderate the financial sector in Luxembourg is not exposed to the same dynamics as in these countries before their respective bail-outs. Luxembourg has a strong sovereign with low debt ratios and the country enjoys one of Europe's lowest unemployment rates. Furthermore, international banks stand behind the local subsidiaries and branches.

The Country Focus starts by presenting the main characteristics of the Luxembourg financial sector, which is composed of three segments, namely investment funds, insurance companies and banks. The subsequent section explains the main activity of the banks, which is international financial intermediation, while the role of deposits and the liquidity position are covered in the last section.

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Some characteristics of Luxembourg's financial sector

The financial sector accounts for a quarter of GDP and directly employs 44,000 full-time equivalents, which corresponds to 12% of Luxembourg's labour force. There are three main segments that will be discussed in turn: investment funds, insurance companies and banks.

Investment funds

3,841 investment funds account for more than EUR 2.4 trillion under management (Commission de Surveillance du Secteur Financier (CSSF) 5/2013, p. 9), making Luxembourg the world's second largest investment fund centre after the USA. Luxembourg is also home to several custodian banks and hosts a major clearing house, Clearstream. When adding assets deposited during payment and securities settlement transactions to the funds under management, the total amounts to EUR 13.8 trillion (CSSF 2012, p. 55). Total money under management already stood above EUR 2 trillion by end-2007, but fell by more than 20% over 2008. Nonetheless, according to the Association des Banques et Banquiers, Luxembourg (ABBL), employment in the fund administration sector has increased every year, including during the Lehman crisis, as a fund needs a certain number of staff to manage it and calculate its net present value (NPV), irrespective of its value.

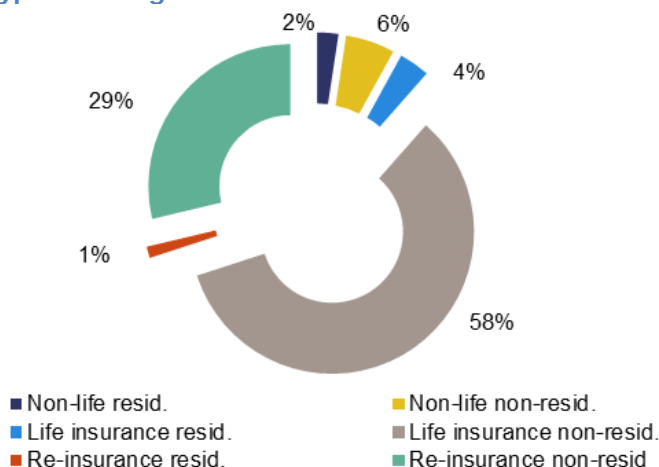
■ *Luxembourg hosts several custodian banks and a major clearing house.*

The biggest boost for the fund administration industry was the creation of the internal market through the Single European Act (SEA). It permitted the smallest Member State to host the biggest fund administration industry. Following the SEA's entry into force in 1987 the client base for Luxembourg-domiciled funds shifted from then 250,000 domestic residents to 350 million potential European customers. Before 1987 the upfront cost for setting up a fund prevented most banks from offering funds to the general public in the Grand Duchy. After this, however, many European banks shifted their fund's domicile and administration to Luxembourg, benefiting from a highly qualified work force, the country's multilingualism, low taxes on funds, and flexible regulations. The funds' accounting operations are done in Luxembourg, whereas in most cases the funds' managers sit elsewhere and investment decisions are made outside the Grand Duchy.

The insurance business

The balance sheet of Luxembourg's insurance sector totals roughly four times GDP (IMF 2011, p. 8). Following a year of stagnation in 2011 it grew by 9.4% during 2012, mainly due to stronger growth in the life insurance business (+13.5%) rather than non-life and re-insurance, which grew with 2.8% and 1.4% respectively. Akin to other financial services, the Grand Duchy's insurance industry mainly sells to non-residents and nearly two thirds of premiums go into life insurances, a close substitute to traditional bank deposits (Chart 1).

Chart 1: Insurance premiums paid classified by type and origin in 2011



Source: Commissariat aux Assurances 2013

■ *Over 92% of insurance policies are held by foreigners.*

The bank sector

Of the 141 banks domiciled in the Grand-Duchy in May 2013, there are 36 branches and 100 subsidiaries of foreign banks, and the remaining 5 credit institutions are from Luxembourg (Chart 2). Only three out of these five are of systemic importance: (i) the state-owned savings bank (Banque et Caisse d'Epargne de l'Etat), (ii) Dexia's former Luxembourg-based subsidiary Banque Internationale à Luxembourg (BIL) and (iii) the local Raiffeisen cooperative. These three banks, together with two foreign ones, (iv) the French BGL BNP Paribas, created through the merger of Fortis into BNP Paribas and (v) the Dutch ING are the five system-relevant institutions catering for the bulk of the

■ *Only 1 bank in 28 is a domestic bank.*

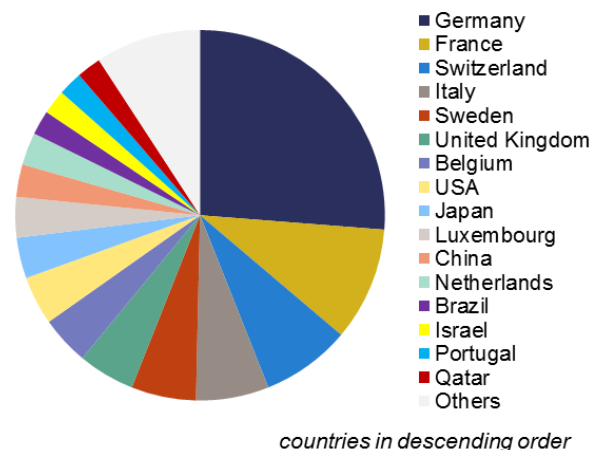
■ Only 5 out of 141 banks are systemically relevant.

■ Luxembourg participated in recapitalising three banks in 2008.

■ Luxembourg has a huge banking sector but a rather small domestic banking industry.

domestic clients' banking needs. During the 2008 financial crisis Luxembourg participated in capital injections for ING, Fortis and Dexia because they were considered systemically relevant. These banks were recapitalised with the help of France, Belgium, the Netherlands and Luxembourg. Each bank's bail-out was different in nature. The three country's contribution was commensurate to the respective bank's importance in the respective domestic economy, which is also reflected in the ownership structures. According to the bankers' association, ABBL, the number of bank employees diminished by 3.1% in the 15 months after Lehman's bankruptcy (ABBL 2009, p. 38) but increased ever since.

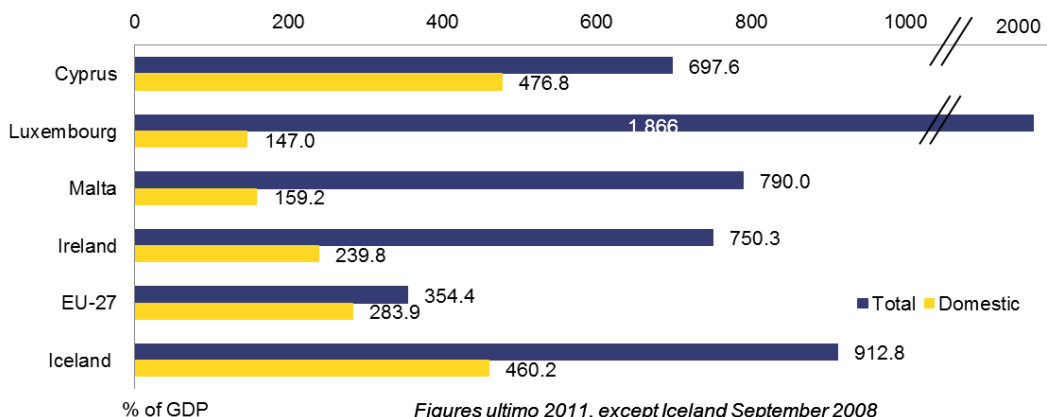
Chart 2: Banks' country of origin



Source: Commission de la Surveillance du Secteur Financier (CSSF 5/2013)

Luxembourg's 141 banks' balance sheet total at end-2012 amounted to EUR 734 billion, more than 18 times its GDP. By end-2011 that ratio in Cyprus, Malta, and Ireland stood close to seven times GDP. Icelandic banks' assets reached nine times GDP before their meltdown in September 2008 (Chart 3). In Luxembourg domestic banks represent only 150 % of GDP.

Chart 3: Banks' assets in percent of GDP in international perspective



Sources: ECB, Central Bank Iceland, Ameco

Credit institutions display healthy soundness indicators in aggregate. Non-performing loans are less than 0.5% of total loans. With an average core tier 1 capital ratio of 15.3% at end-December 2012, banks are already fit for Basel III, as very few banks in the Grand Duchy use capital hybrids, which will see their eligibility phased out until 2019. This ratio increases to 16.6% if only domestic banks are taken into consideration. Return on equity stood at 7.5% in December 2012 and return on assets at 0.5%. Luxembourg also hosts many private banks. Fiduciary services and trustees play an important role as well and most private banks also run operations in Luxembourg. Nonetheless, the relative importance of this sector is evolving as front office duties are shifted to metropolitan areas where their wealthy clients reside, whereas the bulk of back office work remains in the Grand Duchy.

■ Banks display healthy soundness indicators.

■ Many foreign banks use Luxembourg as a conduit for lending to other jurisdictions.

Why does Luxembourg host so many foreign banks?

Most foreign banks have negligible links with the resident economy as they engage only in fund administration, private banking, or act as a conduit for lending abroad.

The country hosts many private banks as it is still perceived as an attractive location for wealth management. Even though transparency on financial assets has been increasing through several EU-led initiatives, private individuals may still prefer to keep their declared assets in the Grand Duchy, attracted by a legal framework which permits the creation of tailor-made vehicles for private wealth management. On the other hand, a worldwide trend to have private bankers work where the high net worth individuals actually live and not where their money is invested led to a relative decline of the private banking sector in the Grand Duchy.

A large part of interbank assets and liabilities are created on the banks' balance sheet as several banks' raison d'être in Luxembourg is to intermediate lending into foreign jurisdictions. The first to do so were German banks. They came to the Grand Duchy in the 1960s at a time when the Bundesbank imposed full reserve requirements on foreign-currency liabilities, whereas Luxembourg's supervisor did not. Scandinavian banks set up subsidiaries in Luxembourg in the 1970s when they were forbidden to lend in foreign currency in their own home markets. Banks from other countries may have had similar motivations, or possibly sought to benefit from the country's multilingualism and more flexible regulations.

Table 1: Banks' aggregated balance sheets

| ASSETS | 2010 | 2011 | 2012 | LIABILITIES | 2010 | 2011 | 2012 |
|-----------------------------|-------------|-------------|-------------|------------------------------|-------------|-------------|-------------|
| Deposits at CB | 26.8 | 64.4 | 54.0 | Lent from CB | 8.9 | 14.0 | 13.4 |
| Lent to other CI | 346.6 | 351.5 | 326.6 | Lent from other CI | 337.2 | 357.2 | 306.0 |
| Customer loans | 171.5 | 177.9 | 163.4 | Customer deposits | 252.4 | 263.7 | 260.9 |
| Securities held for trading | 15.4 | 17.3 | 15.0 | Bonds sold | 72.4 | 66.3 | 65.2 |
| Fixed-income securities | 172.4 | 149.9 | 147.4 | Liabilities held for trading | 15.8 | 18.7 | 14.1 |
| Variable-yield securities | 15.2 | 13.6 | 13.8 | Provisions | 6.0 | 5.0 | 4.7 |
| Fixed and other assets | 14.5 | 19.5 | 16.9 | Subordinated debt | 9.7 | 7.8 | 6.8 |
| | | | | Other liabilities | 14.7 | 15.0 | 15.1 |
| | | | | Capital and reserves | 45.3 | 46.2 | 49.0 |
| Total | 762 | 794 | 737 | Total | 762 | 794 | 737 |

Source: CSSF

Even though regulatory impediments have vanished and most cross-border lending now takes place in euros and does not involve any foreign exchange risk any more, Luxembourg's banking structures and know-how about other jurisdictions' bank regulations remained. Hence, many European banks still channel international lending through their base in Luxembourg for economies of scale and financial expertise available in the Grand Duchy. If a Dutch company needs a loan for its operations in Germany the loan might be channelled through the Luxembourg subsidiary of the company's bank. The Dutch parent bank would lend the amount to its subsidiary (increasing the latter's liability side) which will lend it on to the German operations of the bank's original customer (hence augmenting its assets). These operations inflate the balance sheets of the Luxembourg-based banking sector, where interbank liabilities account for 45% of the total balance sheet (Table 1).

Most subsidiaries hold excess deposits and act as net liquidity provider to their parent bank. Nevertheless, when some parent banks lost access to interbank markets in 2008 several Luxembourg daughters came under liquidity stress. Thanks to the ECB's long-term operations during the winter of 2011/2012, liquidity is less of an issue in the euro area nowadays. The private loan-to-deposit ratio stands at 52% in July 2013, which is low compared to Belgium (59%), Germany (82%), France (109%) or the euro area average (99%). Luxembourg-based banks currently deposit seven times more with the ECB than what they borrow from the ECB.

Deposits and liquidity

Total banks' assets exceed the Grand-Duchy's GDP by a factor of 18. Such a high ratio may look alarming at first glance, given that a linear relation between the size of a country's banking sector and the sovereign's contingent liabilities is often assumed. Yet a more relevant measure is the magnitude of domestic banks, as they appear more likely to warrant support from the sovereign, if so required. Foreign-owned subsidiaries would principally be recapitalised by their parent bank, or, in extremis, the latter's sovereign. At 150% of GDP, the aggregate size of the domestic banking segment is low in European comparison and far below the 475% of Cyprus' domestic banks (Chart 3). Even though non-resident deposits are significant as a whole, they have been stable over the past years and did not lead to rapid asset growth (Table 1). Whereas Luxembourg took decades to steadily build its financial sector, and in tandem the capacity of its supervising authorities, Iceland, Ireland and Cyprus expanded their banks' balance sheet particularly since 2000, outpacing growth in their supervisory capacity.

Despite the fact that overall customer deposits reached EUR 260 billion by end-2012, the Grand Duchy's Deposit Guarantee Scheme (DGS) guarantees only a fraction of this, equivalent to roughly two thirds of Luxembourg's GDP, because a large share of deposits are beyond the insured threshold

■ Most deposits are from non-residents.

■ Most deposits fall outside the scope of the Deposit Guarantee Scheme.

of EUR 100,000. The DGS is liable for subsidiaries, but not for foreign branches. The DGS also covers claims that result from investment transactions, up to a maximum of EUR 20,000. However, the system does not cover insurance related claims (EUR 116.3 billion are invested in life-insurance products).

The DGS was established in 1989 with the purpose of setting up a mutual guarantee system that covers deposits. If a bank fails, the DGS reimburses the guaranteed deposits of each depositor. As in five other European countries, the Luxembourg DGS is funded ex-post. The percentage of the contribution accruing to each bank in Luxembourg is equivalent to each bank's share in the overall guaranteed deposits. The DGS has to pay the guaranteed claims within a period of 20 working days. Since its existence the Luxembourg DGS had to intervene in a minor case involving a Pakistani bank and, more recently, in three banks which were related to the collapse of the Icelandic banking system (Box 1). Overall, all cases were handled smoothly.

■ *Luxembourg's Deposit Guarantee Scheme had to intervene only four times since 1989.*

Box 1: Luxembourg's Deposit Guarantee Scheme had to intervene for the three failed Icelandic banks

The DGS had to intervene for the customers of the subsidiaries of three failed Icelandic banks. Together with the Luxembourg and Belgian sovereign, the DGS was able to compensate the deposits of close to 25,000 customers. Total DGS disbursement to date sum up to about EUR 310 million.

The failure of Kaupthing Bank Luxembourg was responsible for 96 % of the funds paid out by the DGS. The bank ceased activities on 9 October 2008. The deposit banking activities in Belgium were transferred to Crédit Agricole Belgique and those in Luxembourg to a newly created institution, Banque Havilland. The bank's Swiss branch depositors were reimbursed by the Swiss deposit guarantee scheme. The ex-post funded DGS reimbursed close to EUR 310 million of eligible covered deposits. The bank's remaining assets and liabilities, including the liabilities towards the DGS, were transferred to a special purpose vehicle (SPV).

By year-end 2008 the shortfall between the failed estate's assets and its liabilities, including the uninsured depositors, was estimated a EUR 310 million plus a buffer of EUR 10 million. To cover this shortfall the Kingdom of Belgium lent EUR 160 million to the Grand Duchy of Luxembourg, which injected EUR 320 million into the bank, accepting bonds issued by the SPV in return. A tranche of EUR 210 million will have seniority during the recovery period, and repayments will be split equally between the two sovereigns. The remaining EUR 110 million will be repaid pari-passu with the DGS and the other interbank creditors depending on the outcome of the orderly liquidation of the assets in the SPV, which is forecast to end in 2017.

Landsbanki Luxembourg S.A. was ordered to be wound up by a court on 8 December 2008. With the exception of subordinated debt-holders, all other creditors had been repaid in full by 9 June 2009. The DGS recovered its entire debt.

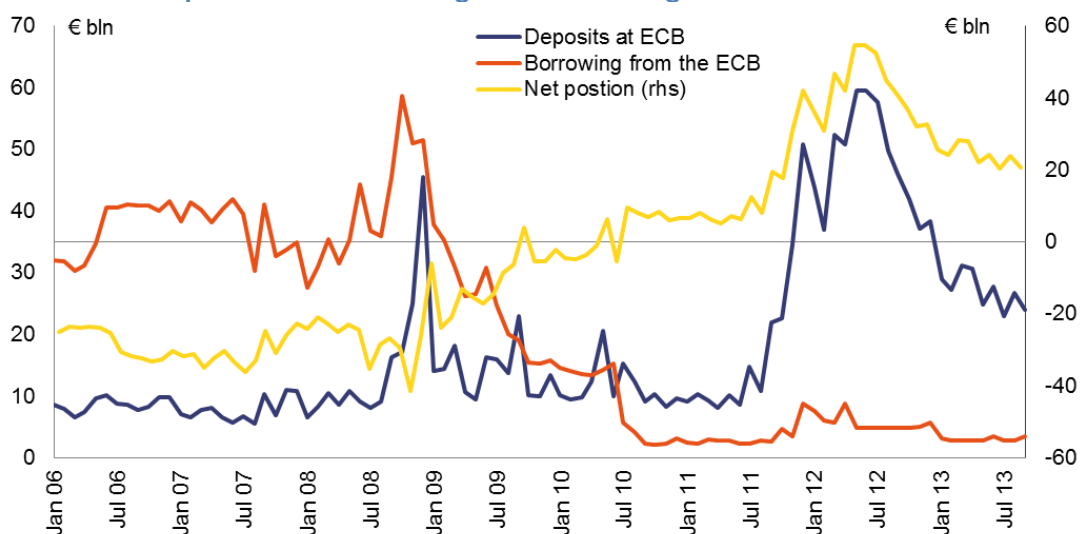
Glitnir Bank Luxembourg was placed into liquidation on 3 April 2009. All deposits, interbank liabilities and trade credits were settled in full by August 2009. The DGS recovered its entire debt. After that date, the Central Bank of Luxembourg (BCL) remained the sole creditor of Glitnir. In 2011, two years ahead of schedule, BCL could recover EUR 1 billion lent to Glitnir through liquidating a substantial pool of collateral pledged previously.

Sources: ABBL, AGDL, Glitnir, Landsbanki, European Commission – DG Competition

■ *Luxembourg's banks currently deposit seven times more with the ECB than what they borrow from the ECB.*

The liquidity position of Luxembourg banks is comfortable. Out of the 141 banks only around 15 use the ECB's deposit and borrowing facilities (CSSF 2012). During the Lehman crisis many foreign subsidiaries in the Grand Duchy pledged collateral with the ECB to obtain liquidity for their parents when interbank markets dried up. In October 2008 gross borrowing from the central bank reached EUR 58.7 billion, nearly four times more than Luxembourg banks deposited with the ECB (Chart 4). This situation inverted in May 2010 and during summer 2012 deposits with the ECB rose dramatically to EUR 59.6 billion, twelve times aggregate borrowings, which were below EUR 5 billion. Recently, deposits with the ECB have exceeded borrowing from the ECB by a factor of seven.

Chart 4: ECB deposits and borrowing in Luxembourg



Source: ECB,

Conclusion

Even though this small country oversees a huge financial sector, attracting a large amount of deposits, Luxembourg specialises in low-risk activities such as fund accounting and private banking. Given the good health of Luxembourg's domestic banks, their low risk profile, long-lasting experience of the supervisor, and the relatively small size of the domestic bank sector, contingent liabilities for the AAA-rated sovereign appear under control. Furthermore, foreign subsidiaries and branches can rely on their parent companies and the overall liquidity situation is comfortable. Finally, the efficient handling of the compensation of lost deposits in the three failed Icelandic subsidiaries in Luxembourg is reassuring.

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