



FIN-USE Expert Forum of Financial Services Users

Providing expertise for policymakers

***FIN-USE Opinion on the Forum Group on
Mortgage Credit Report "The Integration of the
EU Mortgage Credit Markets"***

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Comments to the Report by the Forum Group on Mortgage Credit

Executive Summary

1. There should be binding harmonisation of the Annual Percentage Rate of Charge (APRC). The APRC definition must not be restricted to costs levied by the lender but should reflect the actual costs incurred by consumers as completely and accurately as possible. The APRC must therefore take into account all associated costs.
2. The results of EU-level self-regulation to date in the area of mortgages (i.e., the 2001 European Code of Conduct on pre-Contractual Information on Home Loans) are disappointing. As this Code has demonstrated, in a competitive market, self-regulation must be binding, otherwise, lenders will continue to be able to avoid compliance, irrespective of the effects on consumers. Thus *FIN-USE* opposes Recommendation 15 and agrees with Recommendation 9, i.e., the Commission should introduce a specific regime for mortgages with binding measures on a minimum harmonization basis at a high level of consumer protection including: best possible advice, the right of consumers to redress and the provision of summarized pre-contractual information.
3. *FIN-USE* believes that consumers must be allowed terminate mortgages at any time and under any circumstances. The resultant improvement in customer mobility should serve to increase competition between lenders and in turn, increase consumer choice.
4. If any early redemption fees are levied on consumers wishing to terminate a mortgage contract, then they must be appropriate, calculated in a fair and objective manner, subject to a statutory ceiling and clearly indicated in the pre-contractual summary document. *FIN-USE* supports legally enforceable caps on any early redemption fees.
5. The rights of lenders to terminate mortgage contracts must be balanced against the economic importance of mortgages to consumers; *FIN-USE* therefore favours restrictions on lenders' ability to terminate contracts.
6. Pre-contractual information must be provided well in advance, be standardised and binding. Standardisation would facilitate easy access and understanding of the important aspects of an offer as well as comparing offers from different competitors, thus leading to increased competition.
7. Any advice by lenders and intermediaries must reflect the real demands and needs of consumers. Any offer proposed or promoted by the lender or intermediary that fails to take account of the consumer's situation should be considered flawed. Demands and needs should be assessed on the basis of what the consumer has communicated to the advisor; moreover, it should be obligatory for any advisor to seek-out key information elements (i.e., "Know your client").

8. The applicable law for the mortgage contract should not be defined by a general conflict of law rule based on the principle of free choice. Accordingly *FIN-USE* rejects the proposal for an amendment of the Rome Convention; rather, its specific rules on consumer protection should be maintained.
9. *FIN-USE* disagrees with Recommendation 17 that legally enforceable caps on interest rates and on the variation of interest rates must be removed. In addition, *FIN-USE* proposes that variable interest rates be allowed when they are based on a suitable index, and it is clearly-defined how much the index must change in order to qualify for an alteration of the interest rate, in addition to stipulation of the date when interest rate alterations take effect. Variable interest rates must be transparent, calculable and appropriate for consumers.
10. Existing barriers to completing legally-binding agreements via the internet are justified. The primacy of the written form of a contract should be maintained, given that mortgages are the most important financial decision in the lives of many consumers.
11. The application of responsible lending principles is necessary to prevent consumers from signing credit contracts that were already bound to fail when signing. Yet, responsible lending must not exclude those in real need of credit. A proper assessment of needs and demands would help prevent unnecessary refusals and defaults.
12. There should be a ban on the negotiation of credit and surety agreements in door-to-door situations; consumers cannot thoroughly reflect on all the salient elements of such contracts in such situations.
13. The Commission should consider promoting a binding, standardized format for mortgage contracts based on clear, understandable and readily comparable information.
14. In contrast to the proposal of the industry side, *FIN-USE* believes that before implementing rules on collecting information and access to credit databases, there must be specific regulations on the handling of incorrect data, false claims, wrong information resulting from wrong data, and losses arising.
15. There should be Commission-funded research on the costs and benefits of further integration of the mortgage credit market.
16. Some aspects covered in the Forum Group report concern instruments and aspects that still need further definition before being suitable for commentary. The task of introducing a new legal instrument for a Euro mortgage (26th regime) must be considered in the context of its impact on the *lex rei sitae* and its rulings in detail.

1. Introduction

Given the important amounts of money and long time periods involved, taking-out a mortgage is for most European consumers the single most important financial decision of their lives. Moreover, as a result of increasing property prices¹, mortgages involve ever-larger amounts of money and ever-longer lengths of time², with mortgage repayments constituting the single most important outgoing for European consumers throughout most of their working lives.

It is therefore important that consumers have easy access to clear, concise and standard information, underpinned by a high, common level of consumer protection, in order to allow them compare different mortgage offers, and thus take the mortgage decision that best suits them and their circumstances.

FIN-USE notes that the Forum Group urges the Commission to assess the Recommendations in the Report as a complete package. Nonetheless, as an Expert Forum with a mandate to advise the Commission on the impact of EU Financial Services policy and legislation on consumers and users, *FIN-USE* believes that the following elements merit particular comment insofar as they impact on consumers.

2. General Comments on Report Recommendations

FIN-USE agrees that the Commission should adopt a definition of cross-border lending and monitor it with statistical data. It would be important that consumers be involved in the drafting of such a definition.

3. Additional Detailed Comments on Report Recommendations

Consumer Confidence

FIN-USE supports the proposal that there be Commission-funded research on the costs and benefits of further integration of the mortgage credit market, i.e., “evidence-based” policy-making. There should be full consumer testing of proposed disclosure documents to see how well they work in practice, as well as a mechanism for reviewing and amending such requirements when they do not provide effective consumer protection.

The results of EU-level self-regulation to date have been disappointing. *FIN-USE* believes that the 2001 European Code of Conduct on Pre-Contractual Information on Home Loans failed primarily because it was not binding. The Code is likely to remain inoperable as long as it does not empower consumers

¹ In Ireland real property prices increased by 152% between 1995-2002 (Source: The Economist, 31 May 2003).

² In Portugal 40-year mortgages are now on offer.

with rights. Moreover, the Code covered only pre-contractual information, only part of the necessary information was to be provided, and still the level of compliance was low. Yet, there is much more involved in mortgages than mere standards of information. In the light of the disappointing results of this attempt at EU self-regulation, *FIN-USE* therefore agrees with the Recommendation that the Commission should introduce binding consumer protection rules for mortgage loan contracts on a minimum harmonisation basis, set at the highest level, covering the following areas:

- Duty to give 'best possible advice'. The demands and needs of consumers and the underlying reason for all mortgage credit advice given to consumers regardless of source (including branches and intermediaries) should be specified to consumers on a durable medium .
- The right of consumers to redress (judicial and extra-judicial). The Commission should ensure that redress and enforcement mechanisms/binding rules offer consumers a minimum equivalent protection throughout the EU, at the very least at the highest level currently available.
- The provision of pre-contractual summarised information at the earliest stage of contact between the consumer and the lender or intermediary showing in a standardised European Standardised Information Sheet type format: commission charges, administration or handling charges, total amount borrowed and payable (including APRC, calculation rate, compound period, operation of variable interest rates and total interest payable), the cost of bundled products (direct and the impact on interest), form of product, the exposure period and cost of the Early Repayment Fee (including worked examples of the charge) and amortisation tables.

Any advice by lenders and intermediaries must reflect the real demands and needs of consumers. Any offer proposed or promoted by the lender or intermediary that fails to take account of the consumer's situation should be considered flawed. Demands and needs should be assessed on the basis of what the consumer has communicated to the advisor; moreover, it should be obligatory for any advisor to seek-out key information elements (i.e., "Know your client"). Merely posing a long list of questions from a standard questionnaire cannot be considered to be a well thought-out, balanced assessment.

As part of this work, *FIN-USE* believes there should be a research-based review of the effectiveness of the European Standardised Information Sheet.

FIN-USE would also welcome Commission-funded research on the value from a consumer perspective of pre-contractual information of the kind provided by the ESIS. We must be sure that the information contained in the ESIS allows consumers to easily compare different mortgage offers, and thus take the mortgage decision that best suits them and their circumstances. *FIN-USE* would however like to see the Commission going further, including encouraging efforts to produce a standardised format for mortgage loan contracts. Again with the aim of helping consumers take the most appropriate mortgage

decision, *FIN-USE* supports the creation and maintenance by the Commission of an on-line guide on the main legal and other issues on cross-border mortgage lending.

FIN-USE notes that in some Member States, partial or full repayment is possible at any stage, for any amount, without penalty. *FIN-USE* therefore agrees that the Commission should ensure that consumers are afforded the right to terminate a mortgage agreement at any time and under any circumstances. *FIN-USE* does not agree that consumers should be penalised via early redemption fees for wanting to make early repayments on mortgages. Indeed, *FIN-USE* considers that such fees represent a barrier to consumer mobility and a brake on competition. Moreover, the risk of early repayment is a normal risk (such as default) that lenders already factor into the cost of mortgages. If levied however, any early redemption fees must be: (a) appropriate in length of exposure (i.e. Early Repayment Fee charged beyond the first few years of the agreement must not be allowed), (b) calculated in a fair and objective manner to reflect the cost (if any) incurred by the lender in the wholesale markets and subject to a statutory ceiling; and (c) clearly indicated in the pre-contractual summary document using worked examples. If levied, *FIN-USE* believes early redemption fees should only be acceptable within the first years, and afterwards only if a contractual agreed period of termination (e.g., 6 months) is not respected by the consumer. *FIN-USE* also supports the proposal that where early redemptions fees are levied, they should be harmonised. Similarly, *FIN-USE* believes the Commission should ensure that any legally-enforceable caps on Early Repayment Fees are maintained.

At the same time, *FIN-USE* believes there should be limitations on lenders' early termination of mortgages. Any such early terminations should be balanced against the economic importance of mortgages to consumers. Consumers must also be fully and clearly informed of the circumstances allowing lenders' to terminate mortgages as part of the pre-contractual information. For example, a mortgage that is being correctly serviced by instalments by the consumer may not be terminated by extraordinary notice of cancellation. Even in cases of a brief shortfall in repayments, a preliminary termination should be restricted. Indeed, such preliminary cancellations would lead to consumer insolvency and overindebtedness, without assisting in reclaiming the outstanding loan amount. An example of good consumer protection in this area is the Swedish Credit Act, whereby a lender is only entitled to early termination of a mortgage if it is foreseen in the contract, and if the consumer defaults on repayments for an extensive period, substantially detracts from the collateral or fails to make payment. In addition, the consumer must be allowed at least four weeks to pay off the outstanding balance. A bad example on the other hand is § 490 paragraph 1 of the German Civil Law where the lender can terminate a contract when the consumer's financial circumstances or the recoverability of the security have worsened, irrespective of whether the consumer has made regular interest payments.

FIN-USE agrees that there should be harmonisation by the Commission of the Annual Percentage Rate Charge, in relation to both the method of calculation and the basis of calculation, on a broad basis including all associated charges, and minimum harmonisation. This specification should also be binding for (pre-contractual) information concerning the total amount to be repaid. In many Member States, mortgage insurance for example is compulsory; this and other costs should therefore be included in the calculation of the APR in order to provide a true, comparable cost to consumers. Moreover, despite the aim of ensuring EU-wide comparability, the reality is that different APRC calculation methods continue to be used in different Member States. At the present moment, gaps in regulation still exist which allow banks to make misleading offers even in situations where a calculation technique is specified. *FIN-USE* therefore believes the European Commission should launch an Expert Group to examine this question and propose a satisfactory comprehensive standard.

Ratings of consumers (e.g., concerning the IRB approach of Basel II) can influence and individualise the APRC of a contract; this influence must be restricted. The IRB concept endangers the concept of APRC. Rather, consideration should be given to the standard approach opened by Basel II towards the retail market. Recommendation 26 in the Forum Group Report is of particular importance in this respect.

FIN-USE is also concerned by the question of APRC in the case of bundled products. Here, the issues at stake are even more complex than the above-mentioned and often the reason for overindebtedness. Well-known examples are "Endowment Mortgages" which are still offered by some lenders, with say a duration of 20 years, during which interest is paid, with the capital amount to be paid back at the end via a capital life insurance or an investment fund. The problem for consumers is that the calculation of the earnings of such products is often overly-optimistic, with consumers experiencing unexpected shortfalls in funding upon termination of the loan.

FIN-USE disagrees with Recommendation 17 that legally enforceable caps on interest rates and on the variation of interest rates must be removed. Rather, variable interest rates should be allowed only when based on a suitable index, which must be objective and independent from influence by lenders, as well as controllable and calculable by the client. It is then for the consumer to decide if s/he believes that for example, Euripi-Index or EURO-Swap index is more suitable to his/her personal circumstances. In addition, it should be well-defined how much the index must change in order to qualify for an alteration of the interest rate, and the date should be stipulated when any alterations will take effect. Such measures would help ensure clear comparability of products. Indeed, *FIN-USE* believes that the credibility of APRC information depends on such measures. Ultimately, variable interest rates must be transparent, calculable and appropriate for consumers – the economically weaker party. There should also be a role for national regulators to monitor lenders' application of the index.

FIN-USE also believes that legally enforceable caps on interest rates and on the variation of interest rates should be maintained.

Legal Issues

FIN-USE agrees with the Recommendation that the applicable (substantive) law for the mortgage deed and any related security agreement is the law of the Member State where the property is located (*lex rei sitae*).

On the other hand, *FIN-USE* believes that the applicable law for the mortgage contract should not be defined by a general conflict of law rule based upon the principle of free choice, as it believes that the Principle of Free Choice would tend to prejudice the weaker party, in this case consumers. *FIN-USE* therefore agrees with the Recommendation to retain the specific rules on consumer protection contained within the Rome Convention, as it is unreasonable for consumers to be expected to be familiar with and understand fully the mortgage laws of different Member States.

Moreover, the application of mutual recognition in the area of mortgage lending and the application of foreign legislation to consumer contracts could start a race to the bottom as far as consumer protection is concerned and thereby do little to address consumer confidence and quality of choice. Given the complexity and lack of knowledge of home jurisdictions, 'free choice' is an illusion: consumers would have to accept the choice of law offered by the lender. In addition, the complexity of products and information asymmetry limit any potential benefits to consumers from any extension of choice.

FIN-USE agrees that the Commission should ensure that neutral international valuation standards prevail, or that there exists a single valuation standard ensuring comparability.

While *FIN-USE* recognizes that databases are useful for lenders, they are nonetheless a sensitive issue for consumers. It would be necessary to regulate these databases, including who should have access to the data (perhaps on a permit-based system), which criteria must be met before data are communicated and what information (and when) a registered consumer should be entitled to access. Data about individual consumers should be communicable to a third party only for legitimate reasons, e.g., a creditworthiness scoring. The individual concerned should also receive a copy of the information communicated and be informed of how to correct any incorrect data. It would also be vital that different databases use the same definitions and parameters when determining different levels of payment neglect, and apply the same maximum periods for data storage, after which the data must be destroyed.

Collateral Issues

FIN-USE agrees with the Recommendation for the Commission to provide financial support to the EULIS initiative, to enable and encourage its expansion across the EU.

FIN-USE also believes that pledged securities can be of great importance for consumers (and their families) e.g., the title deeds to a family home. The standardised information mentioned earlier should therefore include information on the circumstances allowing a given security to be enforced by the lender.

FIN-USE would also support the Recommendation to explore the concept of the Euromortgage, for example by way of a study, to assess its potential to promote EU mortgage market integration.

FIN-USE would also welcome the Commission encouraging Member States to increase the transferability of mortgages by introducing pan-European Security Trust instruments.

Distribution Issues

FIN-USE agrees that the Commission should assess and ensure equal treatment of local banks and foreign banks on the basis of the same business, same risks, same rules principle. This should further encourage cross-border competition, therefore improving choice for consumers.

FIN-USE would also support moves by the Commission to revise the legislation covering cross-border services and establishment of branches to include the establishment of representative offices, in order to ensure that there are no disproportionate barriers to the establishment of such offices, as this too should further encourage cross-border competition, therefore improving choice for consumers.

Given the importance of intermediaries, *FIN-USE* agrees that the Commission should introduce a supervisory system for independent intermediaries along the following principles: registration with a competent authority in the home Member State; possession of appropriate professional knowledge and ability (to be determined by home Member State including requirement that the intermediary to be 'fit and proper'); possession of professional indemnity insurance and a complaint/redress scheme in line with requirements for other intermediaries to ensure consistency. Under such a system, there should be a declaration at the outset of the relationship between consumer and intermediary, including all payments including commissions/fees and a stipulation that records be kept of any information/advice given to consumers.

With a view to lightening the load for consumers when taking-out mortgages, and in order to make it easier for them to access competing mortgage offers, *FIN-USE* agrees that the Commission should review which mortgage actions

require written processes and/or a physical presence generally, and review money laundering legislation in particular in order to address current legal barriers to greater Internet use.

FIN-USE also agrees that the Commission should ensure consistency, especially in relation to information requirements, between different directives affecting financial services products, provided this does not result in any overall lowering of consumer protection.

FIN-USE believes there should be a ban on negotiating credit and surety agreements in door-to-door situations. Such sales have for example caused financial hardship to hundreds of thousand of consumers in Germany. On the other hand, mobile banking services used in some Member States do not qualify as door-to-door situations as consumers are familiar with the concept.

Finance

FIN-USE agrees with the Recommendation that the Commission should investigate and address tax distortions, in order to ensure the removal of differences in fiscal treatment between local and foreign lenders. However, *FIN-USE* believes that the Commission should go further and work towards ensuring that all consumers in a given Member State are entitled to the same fiscal treatment, irrespective of the Member State where the mortgaged property is located, or the Member State where the lender is based.

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