

European Union Green Paper on Mortgage Credit in the EU

Response from Prudential plc

1 General Comments

- 1.1 We welcome the opportunity to respond to the Commission's Green Paper on Mortgage Credit in the EU.
- 1.2 Prudential is a leading provider of financial service products in the UK, USA and Asia. In the UK we provide lifetime mortgages for the purpose of **equity release** and accordingly our comments focus on the provision of these contracts.
- 1.3 The Commission is right to recognise in the Green Paper the importance of innovation and the merits of more liquid funding market, "based on modern and flexible funding techniques and products." The recent emergence of equity release products into the market of a number of Member States brings with it the need for careful assessment with regard to such aspects as:
- Consumer protection rights
 - Its role as a new source of finance for consumers
 - Its importance in addressing the pension financing problems of EU citizens now and in the future
 - The broader social context attributed to the use of credit
- 1.4 While it is understandable that the Commission has included equity release products within its overall analysis of the framework for mortgage credit in the EU, we believe that it is critically important to recognise the difference between lifetime mortgages used for equity release, and traditional mortgages used to purchase a property. Any consideration of the provision of mortgage credit needs to recognise that measures that may be appropriate for one type of mortgage may not be appropriate for the other.
- 1.5 We believe that the potential development of equity release markets in Member States depends on a number of factors affecting both the demand and the supply side.
- 1.6 On the demand side relevant factors include:
- the age demographics of the population
 - the level of state and private pension provision
 - the impact of equity release income on means-tested benefits and grants
 - the level of private home ownership
 - the value of property
 - the level of consumer confidence in the product
- 1.7 On the supply side relevant factors include:
- the existence of consumer demand for the product
 - the potential for providing the product profitably
 - the ability to manage the risks involved such as longevity risk, selection risk and property risk
 - confidence in the legal ownership of property
 - access to sufficient financial instruments to back the provision of the loan

- 1.8 At present we do not believe that either the demand-side or the supply-side drivers exist for an EU-wide equity release market and we think it unlikely that one will develop in the short to medium term.
- 1.9 We believe that equity release is still at a very innovative stage. Consumer needs are still developing and providers are looking to respond to these developing needs. We therefore believe that in line with the better regulation agenda the Commission should first ensure that a clear business case for intervention can be identified. The benefits of any policy measure to improve the internal market for equity release products should outweigh the anticipated costs of any proposed measure.
- 1.10 The London Economics CBA study, which accompanied the Green Paper, does not make a clear case for EU intervention in this specific area. In practice we believe that with the different legal systems, property and inheritance laws applying across the EU, and with the varying level of consumer demand between countries, this is an area where the principle of subsidiarity should apply.

2. Background to equity release in the UK

- 2.1 Equity release describes products that allow homeowners to secure lump sums or regular income payments by realising the value of their homes without being forced to move. It therefore has a very different role from traditional mortgages under which homeowners finance the purchase of their property. Equity release products are only provided to a specific demographic group - homeowners who are near to or in retirement.
- 2.2 There are two broad types of product in the UK, the Lifetime Mortgage and the Home Reversion Scheme. Lifetime Mortgages take a number of different forms but operate on the principle that the loan (and any interest on the loan) is repaid on the subsequent sale of the property. Under Home Reversion schemes the lender buys a percentage of the property, at a discount. When the property is subsequently sold the lender will take a share of any capital gain in line with its stake in the property.
- 2.3 The Financial Services Authority regulate Lifetime Mortgages in the UK and we were pleased that the UK Government announced in May 2005 that Home Reversion schemes would also be brought under FSA regulation. This is something we had been pressing for in our response in November 2003 to the Treasury Consultation on the regulation of Home Reversion schemes.
- 2.4 For consumers, equity release raises a number of different issues to traditional mortgages. These include:
- Is the product capable of adapting to changing requirements across the whole of their retirement?
 - What happens if the customer needs to move into a Nursing Home or Long Term Care?
 - What happens in the event of divorce or remarriage?
 - What are the rules about selling the property on death?
 - What is the position of the spouse on the death of the customer?
 - What will be the impact on means-tested benefits and grants?
 - What is the impact on the family and/or beneficiaries?

- 2.5 For providers, Lifetime Mortgages represent a significantly different risk profile to traditional mortgages:
- There is usually a 'no negative equity guarantee' that passes house price and longevity risks from consumer to provider
 - There is an inverse lending risk profile – the Loan to Value increases over time
 - There are long term costs in providing customer options and guarantees, and the long-term capital costs in providing lifetime flexibility
 - There is a need to manage concentration risks and selection risks
 - There is long-term (potentially 35+ years) property price risk
 - There are no regular repayments of capital and interest over the life of the customer
 - There is a need for adequate risk capital to underwrite a 'no negative equity guarantee'
 - There is the cost of providing a fixed lifetime (potentially 35+ years) mortgage rate
 - There are long-term dilapidation risks and the costs of periodic inspections etc
- 2.6 Given these factors we believe it is important that equity release mortgages are considered separately from traditional mortgages and are not subject to the same requirements.

3. Answers to specific questions

3.1 Consumer Protection - Information

- 3.1.1 *Should the Code of Conduct (Voluntary Code of Conduct on Pre-Contractual Information for Home Loans) be replaced by binding legislation or remain voluntary?*

We believe the Code of Conduct should remain voluntary.

- 3.1.2 *What information should be given to consumers? A careful balance must be found between information deficiency and information overload.*

We believe that the UK Financial Service Authority's (FSA) product disclosure requirements (Key Facts Illustration) provide sufficient and comprehensive consumer focussed information. We do not believe it is necessary for the EU to go further than these information requirements.

- 3.1.3 *The Commission considers it fundamental that pre-contractual information is provided at a stage that enables the consumer to shop around and compare offers. Can such a common EU stage be identified, given the variations in Member States' traditions and legislation?*

We believe that by providing a generic Key Facts Illustration the UK customer is in a good position to compare product costs but not necessarily distinct product features. We believe that the current UK rules meet consumer needs and provide a good model for the delivery of pre-contractual information.

- 3.1.4 *Should an information provision regime apply only to lenders or to others such as brokers too? How can compliance with any such regime (binding/voluntary) be ensured?*

We believe that any information provision regime should apply to both advisers and lenders, as it does in the UK.

3.2 Consumer Protection – Advice Provision and Credit Intermediation

- 3.2.1. *Should the provision of advice to the borrower be made compulsory or be a matter of choice?*

We believe this should remain a matter of choice. If consumers have enough knowledge of the products and the options available to them to proceed without advice, they should be able to do so without having to incur the costs involved with using an adviser.

However there is a need to ensure that customers are provided with the information necessary to make an informed decision, and that those who want or need advice are able to access a suitably qualified adviser.

- 3.2.2 *Should conditions be applied to any advice actually provided, whether under a duty or by choice (e.g. standards for the advice, sanctions for non-compliance, advance disclosure of fees, of the adviser's role and recording on durable medium)?*

We believe the customer should be aware of all the relevant costs associated with the product purchase. As far as equity release products are concerned we believe any requirements should be specific to these products and not seek to apply the same requirements as for traditional mortgages.

3.3 Consumer Protection – Early Repayment

- 3.3.1 *Should early repayment be a legal right or a matter of choice? If it is to be a right, should it also be made possible for a consumer to waive this right? Under what conditions? Should this right be subject to a compensation in the form of fees?*

Customers should have the right to early redemption, but providers should be in a position to recover any direct costs associated with the customer breaking the contract. This is particularly relevant to the provision of fixed rate mortgages and to the lifetime mortgage market where customers are provided with fixed interest rates for the life of the mortgage.

- 3.3.2 *How should such fees (whether under a right or a contractual choice) be calculated? Should there be caps, as is the case in some Member States?*

Fees should be related to the financial loss to the provider in either direct costs such as swap option breakage costs, or linked to any customer benefit arising from a front ended discounted rate.

- 3.3.3 *How should the consumer be informed about early repayment? Is there scope for consumer education here?*

We believe early repayment costs should be explicit and disclosed prior to the inception of the contract.

3.4 Consumer Protection – Annual Percentage Rate

3.4.1 What is the purpose of an APR? Information? Comparison? Both?

Both.

3.4.2 Should there be an EU standard covering both the calculation method and the costs element?

Yes.

3.4.3 If so, what kinds of cost elements should such an EU standard include?

In addition to loan interest the APR should take account of all the direct costs relating to that specific mortgage e.g. commissions, legal fees, policy fees etc

3.4.4 The Commission welcomes views on the merits of providing separately information on all costs not specified in the APR, and on the presentation of the effects of the APR in concrete terms such as the cost per month or the overall cost of the loan.

In the UK the APR includes all costs associated with the loan so there are no other costs to disclose. Under UK legislation providers are required to disclose separately in the Key Facts Illustration all the costs included in the APR. We believe that it would be sensible for any EU wide rules to mirror this position.

We believe that it is sensible to show the effects of the APR in cash terms as currently required under UK rules.

3.5 Consumer Protection – Usury Rules and Interest Rate Variation

3.5.1 What are the implications of usury rules for market integration (including any relationship with products such as equity release and mortgage insurance)?

We believe that capped interest rates would be a major barrier to integration in the equity release market. The interest rates at which providers can offer their products will be driven by the cost of financing the loan. Where this cost is driven by commercial market rates, the imposition of a cap on provider's rates by a member state could prevent the provider offering their product in that country.

For equity release products the rates offered correspond to underlying long-term swap rates rather than the minimum bank lending rates that apply to traditional mortgages.

3.5.2 Should this issue rather be examined in a broader, non-mortgage specific context?

We believe that if the issue of interest rate caps is examined it should not be restricted to mortgage interest rates.

3.5.3 *Do restrictions in some countries on the imposition of compound interest rates hinder market integration?*

Yes. It is a key feature of Lifetime Mortgage products that they are based upon compound interest. This is because customers taking out these products cannot afford to make a repayment of capital or interest during their lifetime. Restricting the use of compound interest rates would therefore have a negative impact on the development of the equity release market.

3.5.4 *What impact can they have on the development of particular products such as equity release products?*

Restricting or preventing the use of compound interest rates would have a significant negative impact on the development of the equity release market.

3.6 Consumer Protection – Credit Contract

3.6.1 *The Commission welcomes views on the merits of the standardisation of mortgage contracts, e.g. via a 26th regime instrument.*

There are likely to be significant costs associated with firms standardising their contracts. We are not clear that any benefits arising from such an exercise would be sufficient to justify the costs involved.

3.7 Consumer Protection – Enforcement & Redress

3.7.1 *Should the Commission consider imposing on Member States an obligation to ensure the existence of such alternative means of redress [i.e. mediation or arbitration] in the mortgage credit area?*

We believe the means of redress should be consistent with that applying to other financial service products.

3.7.2 *The Commission welcomes views on ways to reinforce the credibility of existing alternative redress systems, particularly in the mortgage credit area.*

We have no comments to make on this subject.

3.8 Legal Issues – Client Credit-Worthiness

3.8.1 *The Commission welcomes comments on its view that the priority could be to ensure cross-border access to databases on a non-discriminatory basis.*

We do not believe that this is an urgent priority for the Equity Release market, as we do not see an EU-wide market developing in the short to medium term for the reasons previously described. However we agree that the ability to assess the credit-worthiness of customers on an EU-wide basis would be a requirement for the development of an EU-wide market.

3.9 Legal Issues – Property Valuation

3.9.1 *What are the merits of a single EU standard, for both valuation processes and valuers?*

We do not believe that such an approach is practical because of the different national rules applying in such areas as tenure and title, interests in property, insolvency and inheritance regimes. A single EU standard could only be applied if there was equivalence in the whole suite of property law and customs across the EU.

We are also concerned that the imposition of a single standard for valuation processes and valuers would lead to the concentration of expertise in a small number of providers. This could lead to real estate prices being driven up by a small number of sophisticated providers with access to funding methods and capital markets. This could have a significant negative social impact.

Ultimately we do not believe a single standard is practical or desirable.

3.9.2 *What are the merits of Commission action to ensure mutual recognition of national valuation standards?*

As indicated above, we do not believe that such an approach is practical given the different rules relating to property currently applying in each member state.

3.10 **Legal Issues – Forced Sales Procedures**

3.10.1 *The Commission seeks views on the following gradual approach to encourage improvements in forced sales procedures: to first collect information on the cost and duration of these procedures in all Member States and their effectiveness in protecting the interests of all involved, then present it in a regularly updated “scoreboard” and, should this prove ineffective in the long run, consider putting forward more robust measures.*

We do not understand what is intended here. Legal systems across the EU vary greatly, as do insolvency and creditor rules. In addition the reasons for, and the consequences of, a forced sale will vary significantly. On this basis it is very difficult to compare procedures.

3.11 **Legal Issues – Tax**

3.11.1 *The Commission seeks information on similar or other tax obstacles to the cross-border provision of mortgages, which are likely to infringe the freedoms provided for by EU law.*

We are not aware of any tax obstacles to the cross-border provision of lifetime mortgages.

3.12 **Mortgage Collateral – Land Registers**

3.12.1 *The Commission welcomes input on all issues relating to Land Registers, including lenders and investors providing funding for initiatives to improve understanding and access to their contents*

We believe that the role and significance of Land Registers extends a long way beyond the effective operation of an EU-wide mortgage credit market. Therefore we do not believe it is appropriate for mortgage providers to finance the development and improvement of these Registers.

3.13 Mortgage Collateral – Euromortgage

3.13.1 *The Commission invites views on the feasibility and desirability of the Euromortgage.*

We have no comments on this subject.

3.14 Funding of Mortgage Credit

3.14.1 *The Commission is interested to receive views on whether mortgage lending should necessarily be an activity which is restricted to credit institutions, or whether and under which conditions such activity could be performed by institutions which do not take deposits or repayable sums and therefore do not fall within the scope of the EU definition of a credit institution and therefore of all related prudential rules.*

We have no comments on this subject.

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