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Response of the Association of German Pfandbrief Banks (vdp) to the European Commission's Green Paper on Mortgage Credit in the EU

The vdp¹ is pleased to have the opportunity to respond to the ideas put forward in the European Commission's Green Paper of 19 July 2005 on Mortgage Credit in the EU.

We expressly welcome the Commission's approach of first holding in-depth discussions with specialists with practical expertise (Forum Group) on the further integration of Europe's mortgage credit markets before presenting these experts' recommendations in a green paper for broad consultation. This reflects the better regulation principles on which the Commission has announced that future legislation is to be based and which must naturally also apply to any initiatives in the area of mortgage credit.

We refer to the German Banking Industry's (ZKA) response of 23 February 2005 to the recommendations of the Forum Group on Mortgage Credit, in which the ZKA already argued against consumer-protection driven harmonisation of the EU's mortgage credit markets. It favoured instead an approach based on competition and accompanied by a series of measures such as the creation of a liquid secondary mortgage market, a legal framework for efficient portfolio trading, easier transfer of real-estate security interests or the introduction of a pan-European collateral instrument. It was also pointed out that international diversification of credit risk, improved funding conditions and better allocation of capital would allow greater efficiency, which could then be passed on to the customer in the form of more favourable interest rates.

In our view, there is no other workable business model for further European mortgage markets integration than the mutual recognition of mortgage products, based on transparency and consumer information. Common rules addressing product transparency and pre-contractual information shall be provided by self-regulatory tools like the Code of Conduct for Home Loans.

The following comments on the Green Paper also consider the views and recommendations of the impact assessment of the integration of mortgage markets recently published by London Economics (LE).

I. Consumer protection

¹ The Association of German Pfandbrief Banks (vdp) succeeded in early summer 2005 the Association of German Mortgage Banks. vdp currently comprises 22 German Pfandbrief banks, which are among Germany's most important capital providers for residential and commercial property as well as for the public sector and its institutions.

- **Information / Code of Conduct on Home Loans**

In an integrated internal market in which consumers are able to take out mortgage loans also on a cross-border basis, the information provided to consumers plays a key role. An integral element of this interpretation of the internal market is the concept of the well-informed and responsible consumer, who critically examines the loan products on offer in various member states and can then take a decision in full knowledge of all the product-specific facts.

The key importance of product transparency and information is also at the forefront of the LE report. The authors take the view that the goal of giving bank customers access to the full range of products on offer in the EU can only be achieved by providing them with adequate information about the financial products and their associated opportunities and risks. This information should be complete and in as standardised a form as possible so that different products can be compared with one another.

This is precisely the strategy followed by the European banking industry with its Code of Conduct on Home Loans. The pre-contractual information contained in the European Standardised Information Sheet (ESIS) is comprehensive, adequate, and also balanced in order to avoid information overload. The ESIS gives customers all the information relevant to concluding an agreement and thus enables them to gain a complete picture of the loan in question and its associated costs. At most, it would be important to align the duties to provide information that are contained in the code of conduct with those called for under directives such as, the Directive on the Distance Selling of Financial Services.

The German banking industry has invested a great deal of time and effort into successfully implementing the code. The vdp therefore strongly supports retaining the code and its voluntary nature. The code is the only way of responding flexibly to country-specific factors and reflecting the wide variety of European funding traditions without excessive bureaucratic interference. Self-regulation can also adapt more rapidly and effectively to changing market conditions without – unlike mandatory rules – having to go through the whole legislative process.

Abandoning the code or replacing it with mandatory rules would seriously undermine the credibility of voluntary commitments as an effective tool in the internal market. All the more as the LE report sees in the translation of so-called hard restrictions that are legally anchored in the member states into soft law an important contribution to the further integration of the mortgage markets.

What is more, doubts as to the future viability of voluntary commitments would also have adverse effects on member states' efforts to implement the code in their markets (accession countries) or to eliminate remaining shortcomings.

Surveys carried out by the European Banking Industry Committee (EBIC) have shown that it is not possible to standardise throughout Europe the exact point in time when pre-contractual information is handed over to the customer. Due to different traditions across the EU, the modalities on which the conclusion of an agreement is based (process of offering the product, applying for the loan, cooling-off period, right of withdrawal, etc.) vary to such a wide extent that it is not possible to establish a “timeliness” of the point in time of the handover that applies uniformly for all procedures. Nevertheless, it was demonstrated that, in all member states, the ESIS was supplied to customers at a stage which gave them the opportunity to shop

around for alternative offers from other banks before the agreement was finalised. Our association therefore see no need to change the current practice.

Not only financial institutions should be bound by the information requirements, but also brokers or any other intermediaries involved in arranging the loan. It must be borne in mind, however, that these information requirements correspond to those, which are to be imposed on intermediaries of financial services by a dedicated directive already announced in the Commission's Green Paper on Financial Services Policy (2005-2010). To protect consumers from irregular practices by intermediaries, we recommend requiring the latter to have adequate professional indemnity insurance.

- **Advice provision and credit intermediation**

We believe that mandatory EU-level rules on providing advice would be unable to accommodate differences in consumer profiles and needs, particularly since the banks are already aware that it is in their own interests to provide customers with extensive advice.

As the Commission rightly points out in the green paper, different categories of consumers need different information and maintain different kinds of relationships with their providers. In consequence, only non-binding provision of advice can ensure that the consumer is not restricted in his options and that a bank-customer relationship can develop which is geared to his individual needs.

If, say, a customer does not consider the provision of advice to be necessary, he can perhaps opt for an "execution only" product, which could be offered at a lower price than products with advice included. Furthermore, compulsory requirements to provide advice would have a severe impact on the direct marketing of mortgage loans and thus deprive a modern and flexible distribution channel of its generally acknowledged potential for growth.

Nor would standards concerning the advice be able to accommodate the individual nature of each concrete situation. Apart from the potential legal risks involved, which the Commission quite rightly refers to, any advice given to a specific borrower must consider his personal situation, income and other financial circumstances as well as his social environment. Only advice that is geared to a borrower's specific needs, that can be handled flexibly and is not bound to any further preconditions such as, for example, that it be recorded on a permanent data carrier can fulfil this purpose.

- **Early repayment**

We firmly reject regulating the early repayment of mortgage loans by means of legislation. In Germany, mortgage credit is normally extended in the form of fixed-rate loans that are funded on the capital market at matching maturities. Any regulation of early repayment motivated by consumer concerns – such as a legal entitlement to repay the loan at any time – would not only have serious implications for the principles of the German Pfandbrief system but would also, by harmonising an important element of mortgage credit, have a significantly adverse impact on Europe's existing product diversity.

The questions linked to regulation and product harmonisation allude – even if only some areas of the mortgage loan were affected – to one of the core statements made in the LE report to the extent that the greatest benefit for consumers of a fully integrated European mortgage

credit market is seen in the greatest possible product diversity and availability. From a macroeconomic perspective, too, product diversity and availability are identified as the main drivers of future growth in integrated markets. This notion is incompatible with regulation which would effectively banish from the market certain national funding techniques or products such as fixed-rate loans that are refinanced in the capital markets and thus subject to special termination arrangements. As the report says, this would be particularly disadvantageous for consumers who plan for the longer term and are interested in security and predictability. Consumer protection cannot be served by a legal right to early repayment which would result in restricting these fundamental interests of many consumers.

Waiving early repayment

The European Commission also recognises that fixed-term mortgage loans protect consumers. Balancing various interests, borrowers secure themselves low interest rates for the chosen length of the fixed-rate period, protect themselves from interest-rate hikes and undertake in return to terminate the contract prematurely only if a legitimate interest is given. Bearing in mind the basic principle of contract law “pacta sunt servanda”, it would seem only logical for borrowers to be able to waive the possibility of early repayment if they so wish.

This does not in any way give rise to a situation which penalises borrowers or ties them to their bank for an excessive length of time. Fixed-rate loans offer borrowers a high degree of flexibility. With their individual needs in mind and weighing the likely development of market interest rates, customers choose a fixed-rate period at the end of which they can repay the mortgage loan in full and without any early repayment penalty. Such an arrangement can take a variety of forms, such as a combination of longer and shorter fixed-interest periods, depending on the customer’s personal circumstances. The banks also offer special repayment agreements.

Borrowers also have the alternative of taking out a variable interest rate mortgage loan. This can be terminated at any time without an early repayment fee. But there is always a risk of the interest rate rising in response to developments in the capital markets.

Against this background the fixed-rate loan unites all the features necessary for a modern, flexible and efficient mortgage market to function.

Option premium

The favourable market price for the borrower is achieved by refinancing in the form of irredeemable bonds such as Pfandbriefe, whose price is only slightly higher than that of government bonds. This protection against rising interest rates comes at a price, which the borrower would have to pay in the form of an option premium in the event of being able to terminate the agreement at any time without further restrictions. The value of the option varies depending on the time remaining until the loan matures, the agreed interest rate, interest rate volatility and certain aspects of the termination arrangements.

The price can be determined by looking at the situation in the US or Denmark because bonds issued there (mortgage-backed securities in the US, realkreditobligationer in Denmark) are redeemable. This means that the risk of early repayment of mortgage loans is passed on through the bonds to the investors and consumers in the form of an interest markup.

In the mid-1990s, prepayment risk was reflected in typical option-adjusted spreads in the US of 70 to 100 basis points between liquid MBSs and US Treasuries with comparable maturities. In Denmark the option premiums were priced at 30 to 40 basis points in the early 1990s and have since risen even further. Between 1995 and 2004, the interest markups of Danish redeemable Covered Bonds ranged between 100 and 255 basis points compared to the corresponding government bond benchmark. German Pfandbrief-Bund spreads for comparable maturities varied over the same period from only one to low two-digit basis points up to an absolute maximum of 70 basis points (Asia crisis).

Research has confirmed that in all European countries with strict restrictions on early repayment penalties (such as the Netherlands, Italy, Belgium, France and Spain), option premiums are in the region of 20 to 40 basis points even for short fixed-interest periods (cf. A. Dübel, *Festzinshypotheken und vorfällige Rückzahlung in Europa, eine ökonomische Analyse*, vdp Schriftenreihe 2005). This demonstrates that borrowers in all countries imposing no or only minor restrictions on the early repayment of fixed-interest loans, thus causing heavy reinvestment losses for lenders, have to pay a correspondingly high option premium for the right to exit prematurely from the loan agreement.

This makes clear that the option premium for early repayment is one of the most expensive components of the cost of credit and is unlikely to become much less costly in the future. In Germany the price of the option is valued de facto at zero, thus contributing to the high level of efficiency in the German mortgage credit market, which has the lowest lending rates in the whole of Europe.

Early repayment and the principle of maturity matching

The introduction of a mortgage loan that could be terminated at any time would be incompatible with the system of mortgage credit funded by Pfandbriefe at matching maturities even if early repayment fees were able to compensate the bank for its loss in full. This is because if loans are repaid prematurely on a large scale, situations can arise where it is no longer possible to comply with the rules on funding at matching interest rates and net present value cover which have been put in place to protect Pfandbrief creditors.

The principle of funding at matching rates of interest stipulates that the total amount of Pfandbriefe outstanding must always be covered at their nominal value by mortgages earning at least the same level of interest. If, as a result of large-scale repayments or debt restructuring, new loan agreements can be concluded only at significantly lower rates of interest and below those of the interest coupon of the old Pfandbriefe, this principle will be violated. The inflow of funds to the bank from the early repayment and early repayment fee does not satisfy the legal requirements for funding at matching rates of interest.

Making it possible to repay loans at any time can also cause problems with Pfandbrief cover. In the event of the cover pool evaporating dramatically, scenarios are conceivable where the necessary volume of new business can only – if at all – be concluded gradually over a period of time. Since the funds from early repayments and early repayment fees are only eligible as substitute cover to a limited extent, a shortfall in cover may arise. Banks therefore have an interest in long-term loans running their full course which goes far beyond mere compensation for losses caused by early repayment. This is true not only of Pfandbrief banks, but for all financial institutions, since every bank with long-term funding uses the principle of refinancing at matching rates of interest to protect itself against interest rate risk.

Early repayment fees

There must be arrangements in place to ensure that the loss arising from the early repayment of a fixed-rate loan before the fixed-interest period has expired will not be borne by the bank. In Germany, computation methods are applied which have been endorsed by the German Supreme Court and which calculate precisely the loss objectively incurred by the bank. A situation without or with only limited compensation would force the lender to levy an option premium in the amount outlined above in the form of a spread.

Caps or any flat-rate compensation which fell short of the bank's actual interest in performance are to be firmly rejected. Limited compensation models would translate into costs for the bank. Banks would then be obliged to divide potential losses among all mortgage borrowers by raising their rates according to the expected losses, irrespective of whether customers exercised the early repayment option or not. This would lead to inefficient cross-subsidising of users of the early repayment option by non-users. To avoid such a situation, the borrower should be able to select a special type of fixed-rate loan – naturally at a higher interest rate incorporating the cost of this option.

That limited compensation models can result in shifts in market share is demonstrated by developments in other EU member states. The most noticeable effect is a move away from fixed-rate mortgages. In Spain and Portugal, for example, restrictions on early repayment fees have squeezed fixed-rate mortgages out of the market entirely and only variable-rate mortgages are now available. But the lack of a fixed-rate option, in conjunction with corresponding increasing consumer indebtedness during periods of rising interest rates, can result in borrowers finding it extremely difficult to meet their obligations. Such a development cannot be in the interests of consumer protection. Nor can the property market volatility associated with the disappearance of fixed-rate funding be desirable from a macroeconomic point of view.

The conclusions of the LE report in this regard are clear: limiting compensation for early repayment is seen as a barrier to market access and thus as an obstacle to integration of the internal market. The vdp fully supports this view.

Consumer education

In a wholly integrated market with correspondingly wide product diversity, it is very important for consumers to be well-informed. It is therefore essential for financial institutions to ensure that customers are familiar with the product profile of a fixed-rate loan when offering a loan and concluding the agreement, and to supply them with comprehensive information about the modalities of early repayment. Over and above this, one could as a general principle look into possibilities of heightening consumers' understanding of the risk profile of a mortgage loan.

It is naturally not possible to specify the exact amount of a possible early repayment fee at the time the agreement is concluded, since the figure will depend on a number of factors which are not known at this stage. Yet it appears to us to be possible to provide customers with pre-contractual information about the possible amount of an early repayment fee in the form of sample standardised calculations.

It is our opinion, therefore, that the integration of Europe's mortgage markets can be moved forward without the need for a specific degree of consistency or harmonisation regarding arrangements for early repayment or the early repayment fee. It must be possible in a developed internal market for various products with fixed or variable interest rates and different early repayment arrangements to compete with one another to the benefit of the consumer.

- **Annual percentage rate (APR)**

The calculation method of the annual percentage rate for consumer loans was largely harmonised in the 1998 update of the Consumer Credit Directive. Since these rules also apply to mortgage loans in most member states, APRs for mortgages are already effectively calculated on the basis of a uniform and standardised method. On no account should mortgage loans be made subject to a special regime for calculating the APR; this would result in intractable problems of differentiation and impose an unjustifiable administrative burden on the banking industry.

This consequently leaves only the question of standardising the cost elements to be incorporated into the calculation. These can be ascertained by examining the purpose of an APR. Though it is true that the APR is intended to provide both information and a basis for comparison, the comparative aspect is clearly the more important in the European context. Consumers should be in a position to compare the costs of loans on offer in different countries. It could therefore well make good sense to standardise the elements included in the calculation of APRs for mortgage loans throughout the EU.

The comparative function requires a narrow definition of these cost elements, however. Otherwise, the very different cost profiles to be found across Europe would make a proper comparison impossible. The calculation should therefore include only costs which are caused or can be influenced by the lender. For a mortgage loan, for example, these would be interest rate and redemption costs, handling charges, valuation fees or a mandatory mortgage life insurance.

Costs which should not enter into the APR calculation include notaries', land register and estate agents' fees and term life insurance policies which the borrower takes out with third-party providers at his own initiative – for example, for tax reasons. We do not consider it feasible to itemise these third-party costs since the bank is unable to put an exact figure on them. At best, we could envisage informing the customer that such costs are involved and – where possible – of the amount they might reach.

- **Usury rules and interest rate variation**

Usurious interest is illegal in Germany. Legal precedents deem interest rates to be usurious if they are at least 100% more than the range of usual market rates for a particular type of loan.

We therefore take the view that there is no need for usury rules at European level. There is no evidence that this issue has, or is likely to have, a negative impact on market integration. It would not be advisable to introduce usury rules specifically targeting mortgage loans.

Restrictions on interest rate variation or compound interest rates are not to be recommended. First of all, they would run counter to the concept of a fully integrated internal market with

the greatest possible product diversity and availability. Furthermore, such restrictions would fly in the face of the principles set out in Basel II and its implementation in European and national law of risk-sensitive lending and the appropriate pricing of assumed risks.

- **Credit contract**

Standardising mortgage credit contracts would affect the individual profile of mortgage loans in Europe and could ultimately lead to a classic case of product harmonisation. Given that contractual terms and clauses are fundamentals of product diversity and in view of the market-related approach outlined above, we are unable to support such a strategy.

The idea of introducing a 26th regime is currently being widely discussed at both European and national level. Further investigation is required before deciding whether or not it would succeed in promoting the integration of the mortgage credit markets. One advantage of such a 26th regime for mortgage loans would certainly be that it would have no adverse effect on existing product diversity at national level since a 26th regime would complement, not replace, national rules and thus offer additional competition.

- **Enforcement and redress**

In Germany, the ombudsman scheme has proved to be an effective redress mechanism in the area of mortgage credit. Thought could also be given to establishing mediation bodies also at European level. In line with the recommendations of the LE report, it could be beneficial to expand the FIN-NET network, which is already in existence, for the cross-border mortgage loan.

II. Legal issues

- **Applicable law**

The vdp advocates retaining the free choice of law principle enshrined in the Rome Convention, as the choice of law principle is to a certain extent a prerequisite for mutual product recognition in Europe. This applies in particular to the choice of law principle and the associated opportunities for banks to offer mortgage products developed for their home market in as unchanged a form possible in other countries, too. To this end, parts of a contract or at least individual contract clauses would have to be made subject to the application of the laws of the offering bank. It would be a hindrance to integration if conflict of interest regulations such as, for example, Art. 5 of the Rome Convention were to stipulate, systematically and as a general principle, the application of the consumer's home country law for contracts concluded with consumers across borders.

- **Client creditworthiness**

We support allowing all lenders cross-border access to the databases of other member states on a non-discriminatory basis. It is not possible at this stage, however, to go into the detailed modalities of access conditions. The introduction of new database structures should be avoided given the likely costs that this would involve. These implementation costs would almost certainly end up being passed on to consumers.

- **Property valuation**

A distinction needs to be made between the basis and method of a valuation.

The basis of a valuation comprises first and foremost value definitions, valuation principles and the issue of the valuer's qualifications. Property is normally valued by calculating either its market value or its mortgage lending value. The European Group of Valuers' Associations (TEGoVA) has developed standards for both calculations. We therefore entirely agree with the LE report's recommendation that European standards should be applied to the basis of the valuation. Defining the valuation basis by means of a single European standard – an idea considered by the Commission – would in our view not be feasible.

We also favour a European approach when it comes to the qualifications of the valuers. Property valuations should only be recognised if valuers can demonstrate that they have the necessary qualifications and expertise with respect to the market, type of property, objective of the valuation, etc. The relevant guidelines are provided by EN 45013, which requires valuers to hold a certificate of competence. Certification according to EN 45013 / ISO 17024 is characterised in particular by the following requirements: regular, usually yearly monitoring, re-certification (as a rule every 5 years), monitoring to ensure compliance with the code of professional conduct and the obligation to undergo advanced educational training on an annual basis.

Owing to the very different traditions across Europe in this area, however, we would recommend introducing a parallel system of mutual recognition. Along with the certification of valuers under EN 45013, other well-established (domestic) qualifications such as the public appointment of valuers in Germany should also be recognised.

The situation is different with valuation methods. It is true that there are certain similarities in the approaches used in Europe given that, in all countries, rented property is valued according to the income value method while the comparative value or cost value method is applied to owner-occupied property. There are differences in matters of detail, however, since valuation methods always reflect specific market conditions. These differ considerably in the following respects: legal systems, tax regimes and the behaviour patterns of market participants. The principle of mutual recognition must therefore have priority with respect to valuation methods. This is the only way to ensure that property valuations are in conformity with market conditions and can be used, from the German perspective, to derive mortgage lending values.

- **Forced sale procedures**

The value of a real estate lien and the question of how and how quickly the security can be realised are decisive criteria in the lending process. Inefficient forced sale procedures can be a reason to refrain entirely from cross-border activity.

In view of the fact that we are unlikely to see any standardisation or alignment of national forced sale procedures in the near future, it would be a welcome initial step if the Commission made available and regularly updated information about the costs and duration of forced sale procedures in all member states. Any costs ensuing in this connection must however be levied only from parties actually using this service.

- **Tax**

We welcome the Commission's initiative and support it in removing tax obstacles to the provision of cross-border mortgages. The European Mortgage Federation regularly collects information on the existence of such obstacles and forwards it to the Commission.

III. Mortgage collateral

- **Land registers**

Land or mortgage registers fulfil an important function as a source of information about all property related transactions, charges, etc. The data provided by the registers should therefore give exhaustive information on charges over properties in the sense that all existing rights and obligations associated with the property must actually have been entered. It is also important that all lenders should have cross-border access to these registers on the same conditions.

The EULIS project, which is co-funded by the Commission, has made a significant contribution in this respect. We agree with the LE report's recommendation that the Commission should continue its financial support so that the project may be developed further. It would be desirable, and not least make handling more consumer friendly, if appropriate IT solutions were in place to allow real estate liens to be created by electronic means.

- **Euromortgage**

Introducing a European mortgage collateral instrument that is not strictly accessory (Euromortgage) would go a long way towards making national mortgage markets more flexible. It would open up greater opportunities for borrowers to use their property to generate credit. Furthermore, easier transferability of real security is key to the creation of a liquid secondary market for mortgage credit or a mortgage-backed securities market. We therefore support any initiatives of this kind.

A project group recently developed guidelines for a Euromortgage model based on concrete business cases that would benefit from a pan-European, not strictly accessory mortgage instrument (cf. *Basic Guidelines for a Eurohypothec*, Polish Mortgage Credit Foundation, Warsaw, 2005). These guidelines are flexible with the aim of eliminating restrictions on both national and cross-border possibilities of using a mortgage. Making mortgages more flexible from a national and cross-border perspective would improve credit availability, enhance the banks' risk structure and make them less sensitive to external shocks and lead to more smoothly-functioning property financing markets.

The next step should be to evaluate the economic benefits and costs of a Euromortgage at national and international level (impact assessment). We would welcome Commission support for this analysis, possibly with the involvement of external economic experts.

IV. Funding of mortgage credit

- **Liquid secondary markets**

The development of an efficient, liquid capital market for mortgage credit and its funding is key to the successful integration of Europe's mortgage markets. In contrast to the primary market, a mature secondary market combined with efficient funding mechanisms offers a wealth of potential for integration which, moreover, could be exploited in a way that is not system specific.

We therefore welcome and support the Commission's thoughts on creating a working group to analyse in more depth the need for, and nature of, possible action in this area. Making it easier to diversify risk by creating efficient secondary mortgage markets, optimising funding conditions and improving capital allocation (insolvency remoteness of Pfandbriefe and special purpose vehicles for issuing MBSs, mortgage loans as separable assets of the bank) would lead to increases in efficiency to the direct benefit of consumers. We also favour in this context the standardisation of securitisation rules for the cross-border sale of loans and security.

- **Restriction of mortgage lending to banks**

The increasing use of non-deposit based funding mechanisms underlines the growing importance of the capital markets for this business. In no way does this allow a trend towards, or need for, the provision of mortgage loans by non-banks to be inferred.

We firmly reject allowing mortgage loans to be extended by institutions subject to no or only limited supervision by financial services regulators. The extensive supervisory rules which banking business is required to comply with ensure that high standards are met. This also serves to protect consumers. What is more, competition would be considerably distorted if market participants that are not subject to these strict supervisory rules were also allowed to extend mortgage loans.

V. Assessment of the London Economics' study

We are largely in agreement with the analytical part of the study, i.e. with the single market approach on which the report is based and with the proposed list of measures for the further integration of the mortgage markets. The LE report can therefore be seen as confirming our position in many respects.

By contrast, the report's macroeconomic conclusions concerning in particular the model calculations and the anticipated multiplication effects display numerous flaws. Consequently, the statements made concerning the potential an integrated market for mortgage credit would have for growth and for cutting interest rates are largely deprived of their foundations.

- **Single market approach**

The report proceeds from a consistently market- and competition-driven approach. After the authors had taken stock of all the particularities arising from the specific structures and functionalities of the European mortgage markets, the report rightly concludes that the greatest added value of an integrated mortgage market for consumers would be to grant them the easiest possible access to a large number of different funding products. Product diversity

and product availability are the two key terms with which the greatest economic benefits are associated.

In the authors' view, transparency and information for consumers play a central role in this approach since only a well-informed consumer can benefit from the desired product diversity. At this point, the report unequivocally rejects a regulative approach. The recommendation therefore strikes us as logical that compulsory product restrictions anchored in national consumer protection laws be translated into "soft law" in order to eliminate barriers to market entry. Market participants are called on to further develop this thought, which was already concretised with the introduction of the Code of Conduct on Home Loans.

The report's further recommendations all seem to be headed in the right direction. In particular, this applies to the recommendations concerning the development of secondary markets, the improvement of the legal infrastructure for capital-market based funding instruments, making real estate liens more flexible, the creation of a common European valuation standard, greater use of out-of-court settlement mechanisms, better enforcement, better access to land register information, etc.

Ultimately, the authors of the report state unequivocally that they consider the classic product regulation or harmonisation approach to be the wrong way to tap the potential that exists for the integration of the mortgage markets. We share this assessment entirely.

- **Macroeconomic model estimates**

The growth potential calculated by the report is based on undifferentiated assumptions, however, and thus on flawed model estimates.

Demand behaviour

The surprisingly high consumer demand for foreign or cross-border mortgage credit that allegedly exists is put into perspective upon closer inspection of the answers obtained from the persons polled. According to these answers, more than 50% of the interviewees can envisage taking out a mortgage loan with a foreign lender. Yet this willingness is tied to the precondition that this lender is physically present in the consumer's country of residence or at least could actively approach potential customers via a sales network in place there, and that the contracts that are offered satisfy all the requirements of the consumer's home country law.

Thus, the potential demand continues to collide with the two main hindrances to further market integration, namely a lack of distribution structures through which to build up a critical mass of business volume in the foreign markets and the necessity to adjust loans in every country to the specific national legal requirements.

Spread analysis

The report displays serious shortcomings when considering the key issue of economic growth potential.

Even the premise for an optimally integrated mortgage market is, in our view, less than convincing. The report asserts that a mortgage market would be optimally integrated if all existing products were available in all countries for the same prices. But it is not feasible for a product to be priced identically throughout the EU because pricing always depends on

market-specific, bank-specific and risk-specific factors which, given the differences in the structure of European financial markets, cannot possibly be the same. The interest rate on a loan, for example, will inevitably also reflect the lender's transformation efficiency, its access to favourable sources of funding, its risk policy, cost and market position, etc. These differ from lender to lender and from market to market.

We find even more problematic the fact that the average potential for interest rate cuts, calculated at 47 basis points, through a largely integrated mortgage market is founded on a comparison of spreads for which only variable rate mortgage loans serve as the frame of reference. The overnight rates for banks are used as the common benchmark, as only these come close to being the same for all institutions in the EU. The report rightly states that no uniformly comparable rates between the banks in the EU can be calculated for longer-term funding capital. Given that the majority of mortgage loans extended in the EU are fixed-rate loans, however, the method of transferring the potential for reducing margins that was calculated for variable-rate loans only, without making adjustments to allow for the aggregate volume of mortgage loans outstanding, i.e. also for longer-term fixed-rate loans, is highly questionable.

Uniform values for the reduction of margins cannot be taken as a basis for fixed-rate loans, if only because the maturity and credit-worthiness give rise to a specific cost of funds which reflects the risk profile of each individual bank. This creates an extremely diversified margin landscape which produces a correspondingly different scope for cutting margins. It is obvious, therefore, that average margins in mortgage lending of 75 to 80 basis points as are usual in Germany and other intensely competitive markets leave absolutely no scope for interest rate cuts of the magnitude mentioned.

For this reason, not only a transfer of assumptions concerning spread developments in variable-rate loans to fixed-rate loans is out of the question; equally unacceptable is a projection of the potential for cutting margins in the smaller market segment of variable-rate loans onto the considerably larger segment of fixed-rate loans. Consequently, it most certainly does not apply that market integration can create a potential for cutting interest rates by an average of 47 basis points for the entire mortgage lending business including fixed-rate loans.

Multiplicators

The alleged potential increase in GDP of 0.7% is also based on unrealistic foundations. The report's authors arrive at the decisive macroeconomic leverage effect of an integrated mortgage market largely by assuming that an increase in cross-border mortgage lending would ultimately result in higher growth in private consumption. They argue that more cross-border business would stimulate the demand for credit and consequently the demand for housing, which, in turn, would benefit the building industry. Economic growth initiated in this way would therefore finally stimulate a significant increase in private consumption.

It may be doubted whether these strongly consumption-driven scenarios would actually become reality. For Germany, the report estimates that these multiplicators would lead to a – from today's standpoint – rather optimistic rise in the share of GDP accounted for by mortgage debt from currently 54% to 106% in the year 2015, i.e. practically twice the aggregate lendings outstanding at present. In the same period, it is claimed that also for Europe the present volume of mortgage loans outstanding could almost be doubled, from EUR 4.2 to almost 8 trillion.

Upon closer examination, moreover, it becomes clear that the rates of increase of private consumption are also based on the assumption that consumers would mobilise their real property assets for private consumption. This means that consumers who have paid off their mortgage over a period of decades and have finally cleared it of encumbrances liquidate these assets or at least use part of them for private consumption. Yet there are no sound experience values to justify projecting these primarily Anglo-Saxon modes of behaviour onto the situation in Continental Europe. This goes not only for possible behavioural patterns of consumers but as a general principle also for the macroeconomic model estimates used in the report, which are fed with ratios of one EU member state and then applied to or multiplied across all the markets of the Union.

In the final analysis, the integration of the mortgage markets will bring about the hoped-for economic benefits only if it is strongly market-driven. The growth potential calculated by the report's authors is not likely to prove feasible either to the extent or within the timeframe assumed.

In this context, "integration" is a term that may be easily misunderstood. It would be wrong to want to measure the integration of a market solely on the basis of the volume of business transacted across national borders. Instead, it is a question of competition and efficiency of the markets. The fact that most mortgage loans in one country are offered by domestic credit institutions cannot be seen to indicate a low degree of integration of the markets. EU policy should always endeavour to avoid efficiency losses for the consumer.

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