

POSITION PAPER



**EUROPEAN SAVINGS BANKS GROUP (ESBG)
COMMENTS ON THE
GREEN PAPER
MORTGAGE CREDIT
IN THE EU
(Ref: COM (2005) 327 final)
Final Draft**

1 December 2005



EUROPEAN SAVINGS BANKS GROUP



Introduction

The European Savings Banks Group (ESBG) welcomes the opportunity to provide the Commission with its views on the Green Paper on mortgage credit. The ESBG closely monitored the work of the Forum Group on Mortgage Credit, with three of its members being experts of the Forum Group, and is willing to further contribute to the public consultation which will formally end with a Hearing on 7 December 2005.

Assessing the case for Commission action

- a) ESBG shares the Commission's approach: Demonstrating the business case for further integration should be a priority

The Green Paper asserts that action in this area will be proposed by the Commission after the consultation process if it is demonstrated that there is a clear business case for Commission intervention in the EU residential mortgage credit markets:¹ i.e. "*if the potential benefits of intervention can outweigh the anticipated costs of such intervention*"². The ESBG welcomes this approach of the Commission as it clearly demonstrates its commitment to the better regulation principles. In that context, the ESBG agrees that a first priority is to assess whether there is a clear business case – based on well founded evidence - which might justify EU action in this area.

- b) Current level of integration: EU mortgage credit markets - individual markets, but broadly efficient

The Green Paper states that, according to several studies, mortgage markets in the EU are "*not very integrated, notably in relation to the range of available products and cross border mortgage activity, while price differences are already relatively low*"³. Furthermore, the Green Paper refers to a study⁴ where it was highlighted that national markets are individual markets with their own characteristics and economic drivers. As such, the Commission (rightly) recognises that differences in mortgage and housing markets reflect Member State's attitudes to regulation as well as the economic development and cultural factors. These differences are related to factors such as direct government intervention in housing markets (i.e. fiscal incentives to home-ownership), prudential regulation (i.e. regulatory ceilings to *Loan to Value Ratios*), competition in the market, housing rental market conditions, etc⁵.

The ESBG fully agrees with this analysis, but would like to add that the importance of proximity to the customer and the national/local expertise of lenders in a given mortgage market should not be underestimated either, particularly in light of the inherent characteristics of the local nature of the mortgage credit product, the diverseness of the national mortgage markets and of the distribution channels. The Green Paper recognises that the purchase of a

¹ A terminology precision should be emphasized: when the Commission refers to "EU residential mortgage credit markets" it should concern all types of housing loans, including mortgage credits (secured on property) and loans secured on other assets (e.g. personal securities) which are therefore not called "mortgage credit". See ESBG comments on Page 5 under "Scope of the Green Paper".

² Pages 3 and 4 of the Green Paper

³ Page 5 of the Green Paper

⁴ Study on the Financial Integration of European Mortgage Markets, Mercer Oliver Wyman, 2003

⁵ Page 5 of the Green Paper



home for citizens represents the largest purchase in their lifetime. In this context, confidence and trust plays a fundamental role. The ‘proximity issue’ explains for example why mobile consumers buying a secondary residence in a host country are often concluding a mortgage credit contract with a lender in this host country as they generally appreciate the local knowledge (relevant not only for property valuation, but also for establishing a bank account for paying their utility services - electricity or heating bills - required for the secondary residence). Also, based on ESBG member’s experience, the predominant factors influencing consumers’ decisions when choosing mortgage credits seems to be cost first of all followed by proximity (in line with the findings of the London Economics study ⁶, the ESBG believes that cross-border lending through an establishment - branch or subsidiary - remains the most common form of cross-border lending.

Finally, when assessing the need for EU action in this area, the important role that fiscal and social policies play in defining mortgage credit markets should not be underestimated. In this context, it has to be considered that in relation to these two key areas, the Commission has limited competences. Possible EU initiatives disregarding these issues might however render the integration of mortgage credit markets in the EU more difficult.

Also full acknowledgment of the economic reality of mortgage markets is fundamental. Recent studies⁷ have demonstrated that national mortgage markets are highly competitive and efficient. Recent data and comments⁸ suggest that the size of the mortgage market in terms of mortgage debt has doubled in the last decade while the costs of products have halved. Fierce competition within these markets has squeezed mortgage lenders’ margins. Foreign lenders are therefore often discouraged to invest in entering into new markets given the low lenders’ margins and the lack of indispensable local expertise in the foreign property market.

London Economics (LE) study on the costs and benefits of further integration of EU residential mortgage credit markets

The Green Paper on mortgages was prepared and adopted before the publication of the London Economics (LE) study. The Commission has however indicated that interim results of the study have been taken into account in the formulation of the Green Paper ⁹.

As mentioned earlier, the ESBG is of the view that the main focus should be on demonstrating whether the Commission’s proposals to integrate mortgage markets are likely to lead to benefits to both consumers and lenders. Specifically, the ESBG is of the opinion that the ‘business case’ for further integrating Europe’s mortgage markets needs to be clearly proven.

The Commission has made clear that the LE cost benefit analysis of the European mortgage markets cannot be taken to represent an impact assessment of further integration as it is based on a hypothetical package of measures. That said, it considers the LE study as an important

⁶ Page 62 of the study by London Economics “ The costs and benefits of Integration of EU Mortgage Markets”, August 2005.

⁷ Study on the Financial Integration of European Mortgage Markets, Mercer Oliver and Wyman, 2003 and study by London Economics “ The costs and benefits of Integration of EU Mortgage Markets”, August 2005

⁸ Hypostat 2004 and EMF data, as quoted by Simon Walley, in his article „Without frontiers“, the Banker, November 2005

⁹ Annex I, Page 16 of the Green Paper



input in its decision-making on what further action – if any – is needed to further integrate Europe’s mortgage markets.

Given this, the ESBG would like to highlight that the LE study has a number of shortcomings, and that the recommendations and results that emanate from the analysis in the study should therefore be interpreted in light of these shortcomings, which are as follows (and which are developed further in annex 1):

1. Problems with definitions of full integration

The assumption that under full integration the same mortgage products could be available across all Member States at the same price is not shared by ESBG Members, who regard such an aim as neither feasible nor desirable. Not feasible, because while same prices could be achieved for homogeneous products, retail banking products in general and mortgage products in particular are not homogeneous. Not desirable because businesses will always want to compete via prices, even in fully integrated markets, and also because homogeneous products would ultimately reduce customer choice.

2. Optimistic assumptions

We regard a number of their assumptions as too optimistic:

- Too much of the paper’s benefits are dependent on simply increasing product range across Member States.
- Assumptions on the extent by which mortgage spreads would be reduced and converge are very optimistic.
- It isn’t clear that broadening product range would influence demand for mortgage credit to the extent assumed in the study.
- The study does not take account of the heterogeneity of Europe’s housing markets, ignoring, for instance, differences in elasticities of demand due to variations in the transaction costs of house purchase (no less due to different taxation regimes), or other differences in housing markets such as, for instance, the availability of social housing or the existence of an affordable rental market.
- The results of the study are based on a number of other positive assumptions such as an increase in consumer demand, a positive elasticity of housing prices and the possibility of an easier switch to more favourable financing conditions. In addition, their resulting increase in GDP is based on the theory of a perfect market with identical price and service conditions.

3. Questions concerning methodology

The ESBG questions the means by which LE derive their product availability index as well as their estimation of the key mortgage variables.

- The index gives all product ranges equal weighting, thereby overestimating the overall economic benefits of increasing the range of certain types of mortgage products.
- Overall benefits of integration are further over-inflated:
 - o by assuming complete convergence of the spreads to the present lowest level in the EU: a very optimistic scenario.
 - o key explanatory variables are left out of their forecasts on mortgage borrowing (such as income and property prices) which, if included, could substantially reduce the positivity of their estimations.



4. Small players to pay the costs of integration without getting the benefits

We question their admission that further integration will benefit mainly large players, and would expect the Commission to recognise the positive role that diverse actors with different business models play in terms of product diversity and market coverage (provision of various products in urban as well as rural areas) for further market integration. Accordingly, potential future EU initiatives should benefit all market players, be they small or large.

5. Ownership structures as barriers to cross-border entry

The ESBG strongly condemns non-substantiated comments on ownership structures which the authors refer to as ‘non-contestable’, believing that such criticisms have no foundation, legal or otherwise, and certainly have no place in a study which purports to be conducting a serious analysis of mortgage market integration.

Each of the above points is developed in more detail in Annex I of this paper.

Scope of the Green Paper

The scope of the Green Paper is residential mortgage credits, meaning loans granted to consumers for housing purposes. It should however be highlighted that residential loans may be secured not only via mortgages on immovable property (“mortgage credit” stricto sensu) but also by sureties commonly used in a Member State for that purpose (e.g. personal securities used in France). It should therefore be clarified that the scope of the Green Paper encompasses all types of home loans secured either by a mortgage or by any other security commonly accepted in a Member State¹⁰. Equally, and for the sake of both clarity and consistency, all consumer credit agreements should be excluded from the scope of the mortgage credit consultation as they are subject to another set of EU rules (e.g. the Consumer Credit Directive).

Clear definition of cross-border lending

Annex I of the Green Paper, containing horizontal issues which do not fall within the scope of the four areas covered by the Green Paper, gives a definition of cross-border lending (Page 16). Notwithstanding hesitation by the Commission on the need to define cross border lending¹¹, it proposes the following definition: “*there is cross-border lending whenever a service crosses a border, be it through free provision of services, through an establishment (branch or subsidiary) or via an agent*”.

The ESBG welcomes the relevant Forum Group (FG) recommendation inviting the Commission to adopt a definition of cross-border lending and to monitor it with statistical data. This is deemed to be of great importance particularly if the Commission continues to measure integration of retail banking markets predominantly on the basis of cross-border

¹⁰ Consistency of EU terms should be ensured. It is therefore recommended to follow the definition of a “home loans” adopted for the purpose of the European Agreement on a voluntary Code of Conduct on pre-contractual information for home loans (see EC recommendation dated 1st March 2001).

¹¹ Annex I of the Green Paper states that the Commission is not clear as to why this definition is needed. It assumes that it would be useful for the purpose of measuring integration (Page 16).



lending as a main indicator¹². From the ESBG's point of view, cross-border lending is only one indicator of integration. Other indicators which also need to be taken into account are competition, product choice and price margins.

In line with the EC's proposal, the definition of cross-border lending should be broad enough to capture all potential forms of offering and buying mortgage credit in the Single Market. The ESBG survey on cross-border lending experience conducted among its members in 2003 shows that apart from consumers living in border regions (e.g. Alsace) who are more likely to actively seek credit offers from lenders established in different Member States, the likelihood that an 'average' consumer seeks to obtain offers by way of moving himself/herself across the border is fairly limited. A more realistic way of offering mortgage credit products across the border is therefore based on the assumption that it is rather the bank offering its products and services in another Member State than the average customer seeking a deal away from his home country.

ESBG comments on the four areas identified in the Green Paper

Based on the findings and recommendations from the Forum Group of Mortgage Credit, the Green Paper provides the EC's first views on the following four areas: consumer protection, legal issues, mortgage collateral and funding of mortgage credit.

To address the EC's questions related to the four areas under examination, the ESBG would like to submit the following comments addressing the questions in the same order as outlined in the Green Paper.

CONSUMER PROTECTION

➤ Information requirements

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| <ul style="list-style-type: none">• Should the Code of Conduct be replaced by binding legislation or remain voluntary? |
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ESBG members are strongly committed to the Code and urge the Commission to support the Code as it stands – as a voluntary Code. This is a position which is also shared unanimously by all members of EBIC (the European Banking Industry Committee). Continuous efforts have been undertaken by ESBG members to improve the functioning of the Code and some facts could illustrate this, for example the 32 French Savings Banks have taken up the Code in 2003 and have been implementing it since the beginning of 2004. Given that the Commission has now announced that it will make the Code of Conduct available also in the languages of the new EU Member States, it is expected, that the up-take of the Code will further increase.

Further improvements are linked to the question of compliance mechanisms to *objectively*¹³ monitor the implementation of the Code. The ESBG believes that compliance of the Code

¹² The Green Paper on mortgage credit in the EU, under Section I "Assessing the case for Commission Action" refers to the Eurobarometer report of 2004 which states that less than 1% of overall residential mortgage credit activity is direct cross-border sales.

¹³ The first monitoring report commissioned to the IFF – concluded that the Code was not satisfactorily implemented. The ESBG, jointly with the rest of the Code signatories, questioned the methodology and approach used in the monitoring report by sending a formal letter to former Commissioner Byrne. In this context, it should be recognized that some countries such as France were not covered by the survey. In terms of implementation, the situation has improved; a positive development which the 2nd industry progress report will reflect.



could be monitored, if deemed necessary, internally within a credit institution by e.g. legal department, compliance unit or any other special service set up for that purpose.

While clearly reiterating their position in favour of maintaining the voluntary nature of the code, ESBG members would emphasize the efforts made by currently more than 3,800 banks who have implemented the Code and would expect the Commission to take full account of these efforts (in particular with regard to the European Standardised Information Sheet or ESIS) if it should nevertheless consider legislative activities.

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

Pre-contractual information provisions are essential to ensure that consumers make sound, appropriate (to their personal situation) and well-informed financial decisions. Care should be taken to ensure that the information given to consumers is sufficient, while at the same time ensuring that it should not be excessive to avoid the problem of information overload. The ESIS of the European Code of Conduct on home loans contains a uniform and harmonised list of the information requirements primarily intended to encourage consumers to compare different mortgage credit offers from domestic or foreign lenders. The ESBG therefore believes that the type of pre-contractual information contained in ESIS is appropriate to guarantee, firstly, comparability of credit offers and secondly, optimal transparency and quantity of information for consumers, thereby delivering a high level of consumer protection across the EU.

- 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 legislations?

The ESBG is of the opinion that the merits of ESIS are fully guaranteed as long as the lender provides the ESIS at a stage at which the consumer is able to further compare and shop around. Generally and determined by the legal environment in the Member State of location, lenders use one of the two possible scenarios to provide the ESIS: either the ESIS is provided at an advanced stage and in the form of a binding offer; or the ESIS is used at an earlier stage and in the form of a non-binding offer. In the first situation, the lender is bound by the ESIS offer which provides accurately all the information on the terms of the contract while at the same time, it allows the consumer to shop around and compare further offers during the reflection period (i.e. before the credit contract is signed by the consumer). In the second situation, the non-binding offer is provided earlier and is subject to possible changes according to market fluctuations.

Against this background, which reflects different cultures, legal traditions and consumer attitudes when shopping around, the ESBG is of the opinion that it would neither be desirable nor possible to identify and agree on a common EU point in time when the ESIS shall be handed out to consumers. In conclusion, what is at stake is to guarantee that either in one form or the other, the consumer is given appropriate means to carefully compare and consider the mortgage credit product(s) on offer and to take an informed decision.



- 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

As far as the application of the same information regime to brokers is concerned, the ESBG position is that professional credit intermediaries, either independent (e.g. brokers) or linked agents, should also be required to comply with information obligations, at least in situations when their decision is binding for the lender. This could only enhance more transparent and responsible credit intermediary practices.

On the question of compliance, the ESBG would suggest that compliance of the Code could be monitored by the responsible unit of a credit institution which is in charge of compliance.

➤ Advice Provision and Credit Intermediation

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

ESBG members are clearly advising against the introduction of a mandatory duty to advise in this context or in the revised Consumer Credit Directive. Providing professional advice is a separate service which could be offered by the lender or by a third party, e.g. independent broker or intermediary. While lenders will always provide a transparent and clear description of a product or service proposed, the duty to advise should remain a matter of choice for the consumer. The following reasons speak in favour of such an approach: Firstly, the focus should remain on the quality of the information; the lender shall ensure that the appropriate and necessary information on the product/service is given to the consumer so the latter can make the best decision according to his/her specific needs. Secondly, why should advice be imposed on those consumers who are not interested or in no need of advice and who would, as a result, eventually be charged a higher fee/price for this (unrequested) advice? Thirdly, lenders using distance selling means such as the internet to approach consumers might have difficulties in providing advice interactively.

- 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)?

Consumers have very different demands and expectations for products or services on offer. It would not be possible to standardise advice as the latter needs to be defined on a case-by-case approach. The advice should ultimately remain a possibility by which lenders can distinguish themselves from others. If the Commission were to consider it necessary to make the provision of advice compulsory, guidelines for advice would have to be laid down in a precise and detailed manner. As a result, compulsory advice would no longer be tailor-made and personalised so it would be very likely that the consumer's individual needs would not finally be met.



➤ Early Repayment

- 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 compensation in the form of fees?

Early repayment allows consumers to unilaterally decide to terminate the contract. Based on the internationally recognised principle of civil law “pacta sunt servanda”, there should be no mandatory right of early repayment granted to consumers. Instead, the right of early repayment, from the ESBG’s point of view, should be an optional right and both parties should freely agree to have it or not. Lenders however acknowledge the need for such a right under certain circumstances, i.e. unemployment, death or sale of property.

The ESBG would furthermore argue that the introduction of a waiver in those countries where the early repayment is a legal right would enable consumers not interested or in no need to repay earlier to negotiate more beneficial conditions on their mortgage credit contract.

The optional solution might generally also increase product choice as it can be observed that, in some Member States where early repayment is a legal right, long term fixed rate products are often not offered or if offered, are done at prices that are not competitive in the market.

The conditions regulating the right of early repayment should be carefully examined in the context of the type of interest rate products predominant in a given Member State and the specific refinancing conditions available for a lender in that given country. As credit products (e.g. long-term fixed rate or short-term variable rate) as well as mortgage credit funding mechanisms vary greatly from one Member State to another, compensations to lenders for early repayments need to be examined on a case by case basis.

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

The losses resulting from early repayment, which can be considerable particularly in the funding part of fixed interest rate credits, need to be fully recovered, otherwise lenders will not be able to afford granting certain credits thus restricting the range of products offered in the market. It is therefore of utmost importance that any regulation on early repayment fees – in those countries where a legal right to repay exists or where an optional approach is used - guarantees that the lender is in the same financial position as if there had been no early repayment.

There should be no caps on early repayment fees. Restrictions on early repayment fees lead to product restrictions. This can be illustrated via concrete examples, i.e. caps on early repayment fees in Spain have led gradually to fixed-rate mortgage credits almost disappearing from the market. In this light, the ESBG supports the findings of the London Economics study which considers product restrictions, such as legal caps, as obstacles to wider product availability which are detrimental to the consumer¹⁴.

¹⁴ See Page 63 of the London Economics Study.



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

The ESBG is of the opinion that the appropriate means to inform the consumer about early repayment is through clear, concise and transparent information on the existence or not of a right to early repay and the existence of fees if the right is used by the consumer. This is already the case for the large number of EU lenders who provide the European Standardised Information Sheet (ESIS) introduced by the European Code on home loans, which contains a section for the relevant information on early repayment.

➤ Annual Percentage Rate

- What is the purpose of an APRC? Information? Comparison? Both?

First and foremost the purpose of an APRC is comparison. Given that an APRC is provided in percentage terms it merely indicates the cost, but receiving a percentage figure does not illustrate the cost as such. The information on the real cost of the credit is rather provided by the ‘total cost of credit’. The ESBG therefore believes that the APRC serves predominantly to compare credit costs between national and/or foreign lenders.

- Should there be an EU standard covering both the calculation method and the costs elements? If so, what kinds of cost elements should such an EU standard include?

The ESBG is supportive of harmonising the calculation method as well as the costs elements of the APRC at the EU level. Consistency should be assured with the cost elements and the calculation method used in the Consumer Credit Directive.

The ESBG supports a narrow definition of APRC including those costs levied exclusively by the lenders. Third party costs such as notaries, land registers, tax authorities, etc should in contrast not be taken account of when calculating the APRC, because rather than allowing the (cross-border) comparison of lender’s offers, it would result in a comparison of ‘national’ packages thereby rendering all comparison of the credit effectively useless. The nature of the APRC is however not to indicate all costs incurred by the consumer, but as explained above to allow comparison of the range of credits on offer.

- 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?

Complementary to the APRC the borrower should then be fully informed about the further costs of the credit which are not covered by the APRC. To this end, the European Standardised Information Sheet (ESIS), which has been developed in the context of the voluntary code of conduct on home loans, contains sections which foresee the provision of information on “additional non-recurring costs” and “additional recurring costs”.

Information on all costs to the consumer, e.g. those contained within the APRC and other, third party costs (such as listed above) are normally expressed in the total costs of credit, which are commonly indicated in the relevant currency rather than in percentage terms, thereby clearly illustrating the concrete cost for the consumer. It should however be noted that the exact amount of some of these fees are not always available in the first contact stage in all



Member States. In these cases, it is suggested to indicate the relevant cost at least in percentage terms.

Thus, the information on total costs of credits illustrating the overall concrete costs to the consumer is provided with the aim of complementing the (narrow) APRC information, which allows a comparison of different lenders' offers.

Since in some Member States national rules on APRC are applicable to consumer credit as well as mortgage credit, any proposal in this area shall be consistent with the APRC proposal in the new revised Consumer Credit Directive (CCD). In this respect, the ESBG would like to highlight that clarification in the draft CCD proposal is required as to the objectives of APRC on the one hand and the total costs of credit on the other: while the first serves predominantly for comparison, the latter illustrates the overall cost of the credit for the consumer. In the revised CCD proposal, the two concepts are however linked as the APRC is defined as "the total cost of the credit to the consumer expressed as an annual percentage of the total amount of the credit". While the ESBG welcomes that in the draft CCD proposal the APRC calculation is rightly based on the costs originated within the lender, it is concerned, that those costs are (incorrectly) described as total costs of credit. As both concepts serve different purposes, the one (total costs of credit) should not be used as the basis of calculation for the other. Instead, a clear distinction should be made between the two concepts, i.e. APRC and 'total cost of credit'.

➤ Usury Rules and Interest Rate Variation

- What are the implications of the usury rules for market integration (including any relationship with products such as equity release and mortgage insurance)?
- Should this issue rather be examined in a broader, non-mortgage specific, context?

Usury rules are price controls which could lead to distortions of competition. What is more, usury rules and legal caps on interest variation are product restrictions which could negatively impact on product diversity as they potentially hinder product innovation. Product choice benefits consumers and helps creating more competitive and effective mortgage markets. This is also recognised in the study by London Economics which states that "*the immediate effect of the various restrictions is to limit the range of products available and, in some cases, to exclude some groups of consumers from mortgage borrowing*"¹⁵.

The ESBG believes that usury rules and interest rate variations should however be examined in a broader context to assure overall consistency.

¹⁵ Page 64 of the London Economics study.



➤ Credit Contract

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

Whilst the ESBG is in favour of enhancing comparability and transparency of information, (quality rather than quantity), the standardisation of all terms and elements¹⁶ of mortgage credit agreements would not be supported for several reasons:

First and foremost, the ESBG believes that standardisation of mortgage agreements might eliminate or at least reduce to a considerable extent innovative efforts undertaken by the industry to offer a wider choice of products suitable to all types of consumers' financial situations. Second, contract standardisation would imply an enormous legislative task leading to an unworkably high level of regulation which would clearly fail to assure concrete benefits for European consumers. Third, introducing an optional standard pan-European mortgage credit contract would potentially create an uneven playing field and lead to distortions of competition to the detriment of banks located in highly regulated Member States.

Despite these disadvantages, some pan-European players might have an interest in promoting standardisation of mortgage contracts in the framework of an optional 26th regime. The ESBG would suggest inviting the relevant market players who have actively promoted the 26th regime to present more detailed input as well as the necessary clarifications on the functioning in practice of such a concept as well as its pros and cons (a more detailed ESBG position on the 26th regime is enclosed in Annex II and is also included in the ESBG response to the Green Paper on Financial Services 2005-2010). See also our remarks on the Euro-Mortgage below.

➤ Enforcement and Redress

- Should the Commission consider imposing on Member States an obligation to ensure the existence of such alternative means of redress in the mortgage credit area?
- The Commission welcomes views on ways to reinforce the credibility of existing alternative redress systems, particularly in the mortgage credit area.

To date, a wide range of Alternative Dispute Resolution (ADR) procedures on financial services, including mortgage credit, exist at the national level. When existing national bodies join the FINNET¹⁷, although they might operate in slightly different ways, they all comply with minimum equivalent standards to guarantee the ultimate aim of ADR; faster, cheaper and more efficient resolution of disputes between consumers and financial services providers. Against this background, the ESBG does not believe in standardisation of ADR systems because it would require a complete overhaul of existing, well functioning bodies and it would not provide added value for customers. The cooperation of ADR bodies adhering to FINNET is currently organised on the basis of a Memorandum of Understanding, The ESBG believes that such a light, flexible but still efficient approach to benchmarking and exchange of best practices is the appropriate tool to facilitate cooperation and convergence amongst the existing well functioning ADR systems and will also help to flexibly integrate further ADR bodies in the future.

¹⁶ It should be noted that a certain degree of standardised format for pre-contractual information in mortgage agreements already exists through the ESIS.

¹⁷ The European network of national bodies resolving disputes in financial services.



The network of national ADR's which operate under FINNET brings together more than 35 national bodies in charge of out-of-court redress in the area of financial services. This is an important step towards increasing consumer confidence in the Internal Market for financial services. It would be desirable to further promote FINNET in all the new EU Member States and to examine how FINNET is currently working in the EU15 so as to introduce possible improvements in the system.

LEGAL ISSUES

➤ Applicable Law

As of today, at least three potential solutions have been identified within this process:

- Provide for a specific regime for the law applicable to consumer mortgage credit contracts in the future Regulation. This could consist of aligning the law applicable to the mortgage credit contract with the law applicable to the *collateral* contract.
- Continue to subject mortgage credit contracts to the general principles which, in the Rome Convention as it stands, would mean essentially that parties can freely decide on the law applicable to their contract, subject to the application – under some conditions – of the mandatory rules of the consumer's country of residence.
- Exclude the application to a consumer mortgage credit contract of the consumer's mandatory protection rules, provided that some conditions are met, for example that there is a high level of consumer protection in place at EU level.

The ESBG considers the applicable law as an important issue because it is closely linked to consumer protection and consumer confidence. By way of introduction, the Green Paper states that the Rome Convention on applicable law from 1980 applies to mortgage credits. This international Convention is currently undergoing a revision process in order to transform it into an EU Regulation. For the sake of consistency, it is therefore assumed that contract law aspects related to mortgage credit should also be addressed in this revision process. Before commenting on the three possible solutions being proposed in the revision process of the Rome Convention, the ESBG would like to stress that coherence and consistency needs to be ensured between the various Commission initiatives in the mortgage credit area; the planned Rome regulation, the ongoing revision of existing consumer protection directives as well as the work of the Common Frame of Reference on European Contract Law (CFR) where it is planned to organise a workshop in 2007 to examine contractual aspects of loan agreements and other financial services.

Regarding the three possible solutions for the question of applicable law to the mortgage credit contract¹⁸, the ESBG supports the second solution – to continue applying the Rome Convention as it currently stands, meaning the free choice of law by the parties, subject to the application (under some conditions) of the mandatory rules of the consumer's country of

¹⁸ Green Paper, Page 12



residence. The ESBG however urge the Commission to examine closely what are the mandatory rules imposed by Member States in practice, on what grounds and whether equivalence of mandatory rules exist or not in other Member States. If the Commission detects national practices which are hindering the smooth functioning of the internal market it should not shrink back from pointing to possible abuses in the Member States and insisting on bringing about the required changes. By way of assuring full endorsement of the existing regime, it is believed that some of the existing problems could be solved without further regulatory intervention.

The problem with the third possible solution¹⁹ is in terms of the difficulties of ensuring a high level of consumer protection throughout the EU. The ESBG believes that this exercise would only be feasible by means of targeted harmonisation (e.g. full harmonisation of key/fundamental aspects of consumer contracts i.e. APRC, core pre-contractual information).

Finally, on the question of law applicable to the collateral, the ESBG agrees with the Green Paper and endorses the well established principle “lex rei sitae” so the law of the country in which the property is situated applies to the collateral.

➤ On Client Creditworthiness

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| <ul style="list-style-type: none">• Following the same approach as for consumer credit, the Commission considers that the priority could be to ensure cross-border access to databases on a non-discriminatory basis. It welcomes comments on this. |
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The ESBG would like to point out that this matter has also arisen in the context of the revision of the Consumer Credit Directive. The ESBG believes that it is important to first draw a clear distinction between two different types of credit databases: first, credit databases containing basic information and carried either by commercial providers, national central banks or any other authority and second, more comprehensive and complex databases established internally by individual banks.

For the first category of databases, access should be provided on the basis of a voluntary reciprocity system. For this purpose, the use of a Memorandum of Understanding as recommended by the Forum Group would be the appropriate framework to set up the general conditions to define a reciprocity system. Further, in order to assure non-discrimination between domestic and foreign institutions, the latter shall comply with the same requirements regulating access to credit data as the ones imposed upon domestic institutions, notably requirements on the protection of personal data and payment of fees to maintain the database/s.

For the second category of databases, the data collected by individual banks consists of fairly detailed private customer data which are used for internal risk management and prudential purposes and are accordingly treated confidentially. As such, the ESBG wishes to point out that such data should not be subject to any compulsory exchange with foreign or domestic institutions.

¹⁹ Exclude the application to a consumer mortgage credit contract of the consumer’s mandatory protection rules, provided that some conditions are met, for example that there is a high level of consumer protection in place at EU level.



In conclusion, regarding the first category of databases the ESBG agrees with the Commission's approach that the priority in this area could be to ensure cross-border access to databases on a non-discriminatory basis. The ESBG would therefore not agree with other suggested proposals such as asking Member States to establish new databases or setting up a new European credit database given the number of problems which these proposals would imply. Firstly, the costs of creating new databases at the national or even at the EU level are non-negligible. Secondly, should a new database be established – which type of format should it take (i.e. positive or negative regarding the content and public or private regarding the ownership)?

➤ On Property Valuation

- What are the merits of a single EU standard, for both valuation process and valuers?
- What are the merits of Commission action to ensure mutual recognition of national valuation standards?

It is generally recognised that property valuation methods vary across the national borders, reflecting national, regional and local market specificities. Lenders should remain free to choose the property valuation method which is most suitable to their credit practices. A credit institution should therefore not be obliged by law to use a formal property valuation as there might be cases where it is unnecessary, e.g. when the bank is very familiar with a given local property area.

The ESBG would like to emphasize that property valuation management is the sole responsibility of the lender. Therefore EU regulation in this area is not supported. Against this background, the application of mutual recognition principle is deemed to be an appropriate option for cross-border lending situations.

➤ Forced Sales Procedure

- The Commission seeks views on the following gradual approach to encourage improvements in forced sales procedures: to first collect information on the costs 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.

As a general observation, the ESBG believes that there is a need to clarify whether the duration of sales procedures in this context is understood to include the duration of the sales of the property by the lender or whether it only refers to the duration of the court procedure. On the gradual approach proposed by the Green Paper, the ESBG supports the Commission's proposal to collect relevant information, etc and establish a scoreboard. This EU scoreboard, funded and managed by the Commission, would assist in monitoring the national practices in the area of forced sales procedures.



MORTGAGE COLLATERAL

➤ Land register

- The Commission would welcome input on the issues (described in the Green Paper) related to land register records and the EULIS project.

The ESBG welcomes the FG recommendations aiming at improving transparency of property ownership rights and facilitating access to the content of land registers. Maximum visibility of land charges is of utmost importance for the lender as any dysfunction in this respect may negatively affect capital market confidence and cost of lending. The “Erga Omnes” effect (obligation universally recognised) guaranteed in the case of priority ranking of mortgage collaterals is a general legal principle recognised in land register rules in all Member States. The ESBG also endorses the principle according to which priority is given according to the exact time of application for registration and not on the basis of actual registration.

Regarding the EULIS project, the ESBG is of the view that such a model of exchange of practices and information amongst some Member States is worth exploring further. The Commission should therefore continue to financially support the EULIS project.

➤ The Euromortgage

- The Commission invites views on the feasibility and desirability of the Euromortgage. It will, in any event, await the outcome of ongoing initiatives to inform its assessment of this issue.

The Green Paper rightly highlights that the Euromortgage, conceived as a proposal for a 26th regime for mortgage securities, deals with complex issues such as property law (i.e. registration of collateral) and contract law (i.e. accessoriness between the mortgage collateral and mortgage credit). The ESBG is interested in analysing any concrete proposal for a Euromortgage and stands ready to provide the views of its members on this issue.

The ESBG therefore encourages the Commission to invite the promoters of such a regime to publicly present the results of their ongoing work in this area in order to have an informed and focused debate.

FUNDING

➤ Creation of an ad-hoc working group on mortgage funding

- The Commission intends to create an ad hoc stakeholders working group to examine the need for and nature of action on the funding aspects (primary and secondary) of mortgage credit.

At the start of a debate on mortgage funding in Europe, it is important to determine the current state of play in the (mortgage) funding area, analyse what works well and identify where and how future benefits can potentially be reaped.

The ESBG is of the view that national mortgage funding markets operate efficiently and effectively today in Europe. In addition, there have been an increasing number of successful



cross-border initiatives in recent years in this area. We believe therefore that these well-functioning national funding markets and examples of cross-border activities provide a good starting point for further reflections on whether and how potential benefits of creating a pan-European mortgage funding market can materialise.

In this debate, there are a number of issues that need to be taken account of:

Current diversity of funding mechanisms

There is a wide diversity of mortgage funding mechanisms across Member States (e.g. deposits, mortgage backed securities, mortgage bonds). We believe that the respective proportions between funding sources at national level are a reflection of a number of factors, including national legal framework, history and the savings patterns of EU citizens.

Recognizing the existence of factors such as different savings patterns within the EU is important, as this helps to explain why the necessity to establish new (and possibly pan-European) funding systems may vary from country to country. As an example, it can be assumed that in a country with a high savings rate, the need for establishing a secondary market for mortgages will generally be less pronounced than in a country with on average lower savings rates.

No funding scheme is intrinsically better than the others

This diversity in terms of funding methods should however not lead to the conclusion that one mechanism operates more efficiently and should therefore be *artificially* promoted at the EU level. Specifically, the ESBG believes that there is so far no evidence showing that one type of funding mechanism is cheaper and should accordingly be earmarked as the model to be used throughout the EU.

“Completeness” should not be an objective per se

The ESBG is of the opinion that while the availability of a wide mix of funding schemes at the national level can be beneficial, this should not lead to the conclusion that all funding models should be artificially imposed on national markets in an attempt to achieve “completeness” in mortgage funding. What is required instead is to ensure that the funding mechanisms available at the national level, including the envisaged “new” pan European systems, are an appropriate response to the needs of market participants.

ESBG sees clear merits in analysing the potential of integration

This being said, the ESBG can clearly see the merits and is therefore fully supportive of analysing the potential of further integrating the EU’s mortgage credit markets on the funding side, i.e. by discussing pan-European options.

This is in line with the conclusions of the funding subgroup of the Forum Group, which identified a number of (mostly legal) barriers that would have to be tackled prior to establishing a well-functioning pan-European secondary mortgage market. The issues raised by the Forum Group as well as others now need to be studied carefully and in more detail.



Against this background, the ESBG fully agrees with the Commission's proposal to establish an ad hoc stakeholders working group to examine the need for and nature of action on the funding aspects (primary and secondary) of mortgage credit.

We would recommend that the Commission, when establishing this group, assures that the diversity of the funding markets are reflected in the experts that are invited to join the group, e.g. it would be useful to invite experts from countries where banks rely primarily on deposits to finance their mortgages, from countries with a highly developed bond market and from countries with an important RMBS market. In addition, given that the group will be tasked with looking at cooperation models/possibilities at the EU level, it is equally recommended to invite experts who have experience in cooperating within consolidated banking groups as well as experts with cooperation experience within networks/decentralised banking models.

The ESBG stands ready to nominate experts for this group either directly or via EBIC. The ESBG believes that the experience of its members in cross-border lending and in cooperating within networks will bring added value to such a debate.

Finally, the ESBG assumes that the findings and conclusions of the ad hoc group will be made available to the public for wide consultation before any further step is proposed by the Commission.

➤ Pan-European market in mortgage funding

- The Commission is interested to assess to what extent a pan-European market in mortgage funding can be promoted by market led initiatives, e.g. on documentation standards and model definitions to be used in cross-border funding activities.

In the Green Paper, the Commission expresses sharing the view of the Forum Group on Mortgage Credit that the further integration of the EU mortgage markets could be considerably enhanced by the emergence of a pan-European funding market. The EC then states that this premise clearly merits further in-depth analysis.

As pointed out above, the ESBG strongly supports the Commission's recommendation that further in-depth analysis is required. In this context, although the results produced by the ad-hoc working group cannot be anticipated, we would like to mention a number of issues, which would merit further in-depth reflection in the planned debate within the ad-hoc group.

1. The importance of funding via deposits

While it has been said that mortgage funding via the secondary markets is gaining in popularity in Europe, a consequence mainly of declining retail banking deposits due to low interest rates and as customers increasingly seek alternative and more lucrative ways to invest their savings²⁰, recent trends suggest that the proportion of mortgage loans financed with retail and wholesale funds relative to secondary funding remains relatively unchanged²¹.

²⁰ See "The integration of the EU mortgage credit markets", Report by the Forum Group on Mortgage Credit, European Commission, 2004.

²¹ This can be clearly seen in figure A.5. on page 126 of the London Economics study on the benefits of mortgage markets integration.



Specifically, the share of mortgages funding via deposits seems to be relatively stable, reaching circa 60%²². The patterns are however very different across Member States.

Although alternative funding mechanisms are gaining interest in the EU, there are a number of possible explanations as to why deposits continue to be a popular funding instrument for mortgages in Europe:

1. The high savings rate in a majority of European countries, providing a huge mortgage funding source.
2. Retail deposits are a rather cheap source of funding.
3. Deposits are generally not sensitive to bank rating, so the costs of deposits will not rise during a downturn. Contrary to this, if a bank, or its mortgage bonds, are downgraded or traded at wider spreads, the returns on mortgage lending can be severely affected if funding is via Residential Mortgage Backed Securities (RMBS) or bonds.
4. Deposit maturities follow quite well changes in maturities of mortgage loans triggered by rate changes, falling when prepayment is triggered by a rate fall, and increasing as rates rise and maturities lengthen.

The importance of deposits as a funding source can also to some extent be explained by the fact that in a number of European countries, the national legislation does not allow the use of alternative funding sources such as covered bonds or retail mortgage backed securities. Much of the disparity regarding the use of RMBS derives from a lack of market liquidity and sophistication on the part of lenders and investors. This, in turn, is often a function of the high costs of securitisation transactions in some countries, which has deterred lenders from entering this market²³.

These arguments are not made to indicate that deposits are a better funding vehicle, but to make the point that deposits currently are and most probably will be in the future an important source of funding for banks.

2. The need to assess the benefits of increased secondary mortgage funding

The ad-hoc working group should also be invited to identify the benefits which could potentially be derived from the introduction of new forms of funding to provide the Commission with the necessary elements for its further decision making process. The creation of a pan-European market in mortgage funding could bring benefits in terms of increased liquidity and also in terms of cheaper mortgages.

With regard to cheapness of funding however, looking at the US suggests that the benefits of a secondary market may be modest. In the US, where mortgage credits are largely funded via secondary markets, the growth of the securitisation of mortgage loans there has not narrowed the interest-rate spread between mortgage loans and Treasury bonds over the years. One possible explanation is that greater rates of mortgage prepayment have increased the prepayment risk inherent in mortgage backed securities contracts, offsetting any reduction in the cost of financing mortgage loans²⁴.

²² “The integration of the EU mortgage credit markets”, Report by the Forum Group on Mortgage Credit, European Commission, 2004.

²³ Points 3,4,5 and 7 from: “Risk and funding in European residential mortgages”, Mercer Oliver Wyman, April 2005.

²⁴ “The costs and benefits of integration of EU mortgage markets”, London Economics, August 2005.



3. The need to assess what are the likely risks of a pan-European secondary mortgage market.

1.

Members of the ad hoc working group should also be charged with identifying potential risks in the creation of a pan-European secondary mortgage market.

Looking to the US again, where mortgage backed securities account for a third of all the American bond market, the market actions of holders of such instruments in 2003 came very close to jeopardising the recovery of the US economy by bringing the country's mortgage market to the brink of collapse (see Annex III for a more detailed explanation). If it is therefore decided that a EU secondary mortgage market should be established we should be careful to analyse, prior to its establishment, which measures would need to be taken to avoid the replication of a situation, such as that in the US currently, where the actions of holders of instruments such as mortgage-backed securities have that much influence on the stability of the economy.

4. A pan-European secondary mortgage market without state guarantees

2.

In exploring the possibility of enhancing market integration through the development of a pan-European funding market for mortgage credit, the Forum Group acknowledges the existence of a number of successful domestic funding vehicles²⁵ in several EU countries and mentions the idea of a European Mortgage Finance Agency (EMFA), modelled on the examples of the US Government Sponsored Enterprises Freddie Mac and Fannie Mae, which has been proposed as a way of replacing what EMFA considers to be a fragmented European MBS market with a more standardised pan-European one²⁶.

In its conclusions however, the Forum Group makes clear that it is not in favour of seeing such a model being replicated in Europe, stating explicitly that it is opposed to any initiatives aimed at introducing any form of institutional guarantee and support (from either the EU or national governments) that might distort competition or create barriers within the national and European markets.

This means that mortgage loans in Europe will have to continue being funded on the basis of the financial strength of banks or the intrinsic quality of the securities. In the ESBG's view, it should be one of the ad-hoc working group's task to establish how this can be done successfully in a cross-border context.

5. The conditions for establishing a pan-European secondary mortgage market

The conditions for establishing a pan-European mortgage market across Europe should be identified carefully by members of the planned ad-hoc group, in particular in light of existing experience in this area.

One particular pan-European securitisation project which was led by a management consultancy and four European banks, and which lasted between 1999 and 2001, deserves consideration and perhaps some further investigation. The idea was for the banks involved to combine their mortgage portfolios with the usual objectives of such an exercise in mind, i.e:

²⁵ Such as facilities like the French CRH (Caisse de Refinancement de l'Habitat), the Spanish AyT (Ahorro y Titulización), mortgage banks such as Danish Totalkredit, and the Italian Credit Circle.

²⁶ "The integration of the EU mortgage credit markets", Report by the Forum Group on Mortgage Credit, European Commission, 2004.



achieve pan-European diversification to derive credit enhancement benefits from the rating agencies, generate very large volumes of issuance and allow the involvement of smaller banks, and to develop European benchmark mortgage backed securities as an alternative to Euro denominated Government Bonds. The banks were from Spain, Germany, Italy and Switzerland.

Findings from the project were that there were some diversification benefits from combining pools from other jurisdictions, but that these were apparently marginal, and also that the legal, technical and commercial obstacles to defining the sharing of benefits far outweighed the advantages. The main technical and commercial problems were that the banks had very different assets and securitisation objectives: the Spanish and Italian banks had generic amortising floating rate mortgage pools that were cash securitisable, the German bank wanted to pursue a funded synthetic and the Swiss bank had fixed rate collateral denominated in CHF with little amortisation and higher credit quality. In fact, it was concluded that a mortgage platform was near to impossible given the diversity of asset characteristics and securitisation objectives of the four banks.

These findings and the conclusion from this project are very interesting given that they identify the difficulties which need to be addressed before establishing a pan-European platform. Using such examples as case-studies is vital as a preliminary assessment of the need for a pan-European mortgage market.

6. National markets development required to deepen the integration of European mortgage markets

The consideration of a large pan-European market in mortgage funding should not detract us from focussing on all that can be done at the domestic level to improve the efficiency of national markets for mortgage credit and which in turn could deepen the integration of European mortgage markets.

As an example, the insights of the Miles study²⁷ are worth considering as it puts forward a number of recommendations on how the mortgage market in the UK can be helped to work better.

With regard specifically to recommendations to lenders of mortgages, one problem that is highlighted in the report is that the lack of specific covered bond legislation in the UK could explain why the use of covered bonds (one instrument that could be used to fund long-term fixed rate mortgages) is not popular there. In addition, it is pointed out that the lack of such legislation “could prevent recognition of these bonds for the purposes of the Coordination Directive on Undertakings for Collective Investments in Transferable Securities (UCITS). This would reduce the extent to which European investment funds can invest in UK issued covered bonds”.

Another finding is that writing call options could have the potential to help reduce volatility for regular issuers of long-term fixed-rate bonds, when there is uncertainty about future

1. ²⁷ ‘The UK Mortgage Market: Taking a Longer-Term View’, David Miles, Imperial College London, March 2004. The Miles study was conducted to give recommendations both on ways to improve the advice and information to borrowers and on ways to reduce the cost to lenders of offering several different types of mortgages.



interest rates, and therefore that Government should give further consideration to the potential costs and benefits of Government issuing interest rate derivatives.

The study is country specific, and its recommendations are therefore not widely applicable to European countries, but it does help to highlight that changes can be brought about at the domestic level which can render national markets more effective and which can indirectly improve the integration of European markets. This remark also points to the importance of applying the principle of subsidiarity, where relevant, by making a distinction between issues that should be addressed at the EU level and issues that would be better tackled at the national level.

7. European mortgage markets are not homogenous.

The main challenge in the creation of a pan-European market in mortgage funding is related to the different rules, structures, habits, etc. in the different EU Member States.

For example, whilst most mortgage loans in the UK and Spain have a floating rate for most of their lives, in other European countries, fixed rates are more common. In France, for example, fixed-rate mortgages are on offer, most frequently for 15 years. Refinancing, which allows borrowers to lock into lower rates as and when they occur, is possible. And there is only a penalty of up to six months of interest or 3% of the balance that is being prepaid. In Germany, rates on mortgages are fixed, typically for ten years, and there is a prepayment option, (in specific 'stress' situations), but the full costs of refinancing needs to be covered by the borrower. Italy's market is a hybrid of fixed and floating regimes.

An important task of the ad-hoc group on funding will be to examine the potential for a pan-European secondary mortgage market in light of these national differences.

8. The Capital Requirements Directive (CRD) – a necessary tool for establishing an EU mortgage bond market

In the context of the discussions relating to the establishment of a pan-European market in mortgage funding, one element could play an important role: the recent adoption of the Capital Requirements Directive (CRD), which still has to be implemented in the Member States.

An important aspect of this Directive is that it addresses the question of covered bonds from a risk-oriented perspective. Specifically, the CRD builds on the definition of 'covered bonds' contained in Directive 85/611/EEC (UCITS) by specifying criteria which have to be fulfilled (for example in terms of eligible assets by which the bonds have to be collateralised) in order to benefit from a particular risk weight or Loss Given Default (LGD).

The ESBG is of the opinion that the approach followed in the CRD could be a first step in the convergence of the definitions of covered bonds applied in the different Member States (specifically in terms of the criteria used), which in turn could result in the creation of a more pan-European market for mortgage bonds.

In any event, as it is not possible at this stage to foresee the impact that the CRD will have on the creation of a pan-European market for covered bonds, the ESBG would strongly recommend to the Commission to further analyse this issue closely in the context of the forthcoming discussions on the establishment of such a market.



➤ Mortgage lending by institutions others than credit institutions

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.

Regarding the question of extending the activity of mortgage lending to non-credit institutions which do not comply with EU prudential rules, the ESBG believes that compliance with prudential rules, notably the Capital Requirements in the EU, is necessary in mortgage lending to guarantee solvency and adequate risk management.



Annex I – ESBG Comments on the London Economics Study

In this section we present our views on the Study of London Economics in more detail:

A) Main weaknesses/possible problems arising from the study:

1. Problems with definitions of full integration

The study adopts the following definition for full integration of EU's mortgage markets: *“The same range of mortgage products is available in all Member States at the same prices.”*²⁸

The assumption that under full integration the same mortgage products could be available across all Member States at the same price is however not shared by ESBG Members, who regard such an aim as neither feasible nor desirable.

Not feasible, because while same prices could be achieved for homogeneous products, retail banking products are not homogeneous.

Not desirable because businesses will always want to compete via prices, even in fully integrated markets. In markets where purchasing power is higher, businesses will charge as high as possible to reap as much of the consumer surplus as possible. Also some of the most competitive markets have high price discrimination, as it is a typical profit maximising strategy in very competitive markets i.e: airline tickets. Some would say that the more price differentiation, the more competitive the market, as price is one of the key means of attracting consumers. Finally, price differentials could be expected to exist across different markets in the same country (i.e: to reflect market differences in rural and urban areas for example), and so there is no reason why these couldn't exist across different national markets.

2. Optimistic assumptions

On page 83 of the study, the authors reveal that they expect mortgage integration to affect two mortgage variables directly: mortgage spreads and product availability. Interestingly, their analysis of current differences in mortgage spreads between EU countries reveals small differences in spreads. Therefore full integration would improve little on one of the two main variables which they use to describe it.

On page 84, the authors make the dual assumption that the mortgage spreads on identical products in all EU countries would converge to the lowest spread in the EU, and that the lowest spread existing in the EU as a result of integration would itself be lower than the lowest spread currently existing. Such optimism is equally reflected in the results, but one would have to question the realism behind the assumptions that such ambitious goals would be reachable in practice.

On page 88, the authors add that one feature of their definition of full mortgage integration is that the range of products available would be as wide as that of the country

²⁸ Pages 16 and 17 of the study by London Economics “ The costs and benefits of Integration of EU Mortgage Markets”, August 2005.



with the most developed mortgage market at present. This is based on their belief that greater product availability would increase mortgage borrowing. The author's seem to believe that increasing the range of products available will increase mortgage lending. ESBG would suspect however that after taking into account the level of interest rates, and the opportunity costs of buying a mortgage (i.e: continuing to rent, and never owning anything) – including the transaction costs – product range really only occupies a very small place in people's decision-making on whether or not to get a mortgage; and consequently that varying the range of mortgage products would - *ceteris paribus* – have little influence on demand in most European – especially the more sophisticated – markets.

Yet, looking at page 89, LE predicts for instance that increasing product availability will, by itself, lead to the following changes (2003 to 2015) in mortgage debt as % of GDP: France: 24.8% to 62.8%, Spain 42% to 82.4%, Germany 54.3% to 106.6%, i.e for these countries, more than a doubling (as GDP also increases) of the size of their mortgage markets in that time period. That seems very optimistic.

Also, it would be worthwhile looking at the heterogeneity of housing markets in Europe and try to put it into the context of the authors' findings. For instance, their findings are based on the assumption²⁹ that one of the gains from new measures that would induce full integration is that consumers will switch from renting to owning property. The extent of such a change, however, will be very different from country to country at least in part due to the differences in transaction costs from one country to the next. Taking Belgium as an example, if their package of measures doesn't include a significant fall in the taxation rate of housing purchases (given that house purchase taxes are very high in Belgium), the switching is not likely to be significant. In spite of that LE expect a 65% increase in mortgage debt outstanding between 2003 and 2015 for Belgium alone.

Not least, other factors which will have an effect on the growth of mortgage debt include demographic trends (which are decreasing in Europe), and the influence of current home ownership ratios.

All in all, the positive results of the study are based on an increase in consumer demand, a positive elasticity of housing prices and the possibility of an easier switch to more favourable financing conditions. In addition, their resulting increase in GDP (of 0.89%) is based on the theory of a perfect market with identical price and service conditions. Further, only in a perfect market would it be possible for the consumer to browse the European mortgage market, comparing 'homogenous' mortgage products and finally choosing the best product out of all existing products in the EU. For these and the reasons above, LE's full integration scenario is a very positive scenario indeed.

²⁹ See page 94 of the study by London Economics "The costs and benefits of Integration of EU Mortgage Markets", August 2005



3. Questions concerning methodology

First step: deriving the product availability index

One important element of the London Economics model used to quantify integration is their development of a product availability index.

The basis for the calculation of the index is a survey conducted by London Economics among selected mortgage providers (banks and associations of banks) in the countries of the EU. Though the group of those questioned was fairly small with only one association or, in some cases, only one bank per country, the representative nature of the results is not called into question here in view of the specialist qualifications of the interviewees.

In this survey, the interviewees were asked about the current availability of 9 specific mortgage products (see page 142) in each EU country. Based on the replies, an overall score was then calculated for each country by simply adding up the points assigned to the respective questions (already available = 10 points, available to a limited extent = 5 points, not available = 0 points). This was then standardised on a scale of 0 to 1 based on the overall score for Great Britain – deemed to be the market with the greatest product diversity - (all products available = 90 points or index value 1).

One problematic characteristic of the index as far as we can see it is the fact that each of the 9 different product ranges is calculated into the index with identical weighting. As an example, this means that the availability of mortgage products for persons over 30 years old (one of the 9 product categories) – the category which more than likely includes the broad mass of potential customers - is, in calculating the level of development of the respective national mortgage market, given equal weighting as, for instance, the availability of mortgages for special customer segments (such as credit impaired borrowers, and self-employed borrowers).

This has very considerable consequences for the subsequent econometric calculations as this overestimates the overall economic benefits of increasing the range of “niche and marginal group products”.

A more realistic construction of the product availability index would at least require a rough weighting of the different product categories on the basis of plausible factors. For example, the market potential and, therefore, the weighting factor of an offer for younger households (under 30) or for self-employed people could be gauged - on the basis of a simple headcount for instance – and in this way differentiated in importance with the basic offer for households over 30 years of age. The effect would be a significantly lower weighting for “niche products” in the index and therefore a consequently much lower overall economic growth prediction resulting from the introduction of such products.

Second step: estimation of key mortgage variables

The product availability index mentioned above is then used by London Economics to estimate the evolution of key mortgage variables (mortgage spreads and product availability – via loan volumes) under both a basic and a full integration scenario.



a) Forecasts of mortgage spread convergence

Under the basic scenario (without integration measures), London Economics assumes that the interest spreads between the different countries of the EU will converge in the future at the same rate as for the year 2003/2004. This means that considerable differences in interest spreads would still remain by the year 2015 (last year of forecasts).

Under the integration scenario however, London Economics assumes that complete convergence of the spreads to the present lowest level in the EU (the Netherlands) will take place between 2005 and 2010. No reasoning is given for making such an assumption, which is highly questionable.

b) Forecasts of product availability

London economics explains that the assessment of trends in product availability would ideally be done using time-series data on the range of products available in EU markets. They add however that instead, the data which they use only refers to the current situation, and thus that they estimate recent trends in product availability. They do this by comparing recent trends in outstanding mortgage debt across countries, explaining that in their view greater product availability will increase consumer mortgage borrowing.

London Economics thus uses their product availability index as an explanatory variable for the prediction of increases in mortgage borrowing. Apart from the index, the rate of interest and a dummy variable (representing new Member States) are included in the regression as further explanatory variables.

Other important influencing factors are thus completely ignored. For instance, the income level (although it is taken into account to a certain extent via the dummy variable for the “acceding countries”) and the growth of property prices in the individual countries are left out of the model. The latter is particularly important because a disproportionate rise in property prices in comparison to GDP or to private consumption would have a direct and considerable influence on the size of mortgage debt.

The level of mortgage debt is thus explained in a virtually monocausal manner arising from the product availability index (including the weaknesses of the index, as pointed out above). The consequence is the assumption in the model of a level of correlation between product diversity and the size of the mortgage debt market which has been too simply derived and which is too positive.

This is made clear by the results of a simulation calculation explicitly presented in the study which reveals the effect of implementing the package of “integration” measures on the importance of housing mortgage debt (i.e. without any changes in other influencing factors)³⁰:

If these simulation results are compared with the corresponding product availability indices (cf. annex), it becomes apparent what importance in the model the effect of an increase in product diversity is assumed to have on the volume of housing mortgage debt.

³⁰ See Table 8.1, p. 89 of the study by London Economics “The costs and benefits of Integration of EU Mortgage Markets”, August 2005.



Third step: overall economic simulation

If the rates of debt determined from this simulation are compared with those from the overall economic model, only marginal differences emerge for most countries.

For instance, a 99.5% rise of the proportion of debt as a share of GDP is forecast for Germany compared to one of 96.3%. The influence of other determining factors thus remains extremely limited in this instance and the overall economic simulations show themselves more as rather cosmetic in this respect.

The weaknesses of the modelling at the previous levels of the overall economic model finds expression, however, with the same stringency in the results of the model, with a 2.8% increase in housing stock forecast as an “integration effect” for Germany, for example. At the same time, however, housing construction loan debt is supposed to more than double (+100.5%). London Economics rightly points out that this substantially higher rise has to be based on two effects: on a rise in the rate of home ownership compared with rental, as well as on an increase in property prices. The authors do not reveal what specific division results from the model in this regard.

Incidental question: index for the Czech Republic – from what source?

It would be interesting to know how London Economics derived the product availability index for the Czech Republic³¹ without apparently questioning one single provider from that country³².

4. Small players to pay the costs of integration without getting the benefits

The study recognises that “*it is likely that only large lenders would be in a position to engage in cross-border trade in mortgages in the near future. Small lenders are also less likely to be willing to pay the large cost of entry via building new branches or M&A.*” This is implicitly recognising that there is a risk that integration might benefit only a limited number of banking actors, while the costs of integration will have to be paid by all market players. The ESBG would expect the Commission to recognise the positive role that diverse actors with different business models play in terms of product diversity and market coverage (provision of various products in urban as well as rural areas) for further market integration. Accordingly, potential future EU initiatives should benefit all market players, be they small or large.

5. Ownership structures as barriers to cross-border entry

Landesbanken and savings banks are explicitly mentioned in the section on obstacles to cross-border entry, where it is said that “*the capitalisation measures their public owners used to support their rating is still contentious*” (page 74). On page 73, it is stated that “*non-contestable ownership structures of banks such as foundations and public-law ownership remain an issue in several jurisdictions (Sweden, Germany, Spain)*”

³¹ cf. Tab. 4.2, p. 56 of the study by London Economics “The costs and benefits of Integration of EU Mortgage Markets”, August 2005.

³² cf. Tab. A.8.15, p. 180 of the study by London Economics “The costs and benefits of Integration of EU Mortgage Markets”, August 2005.



Such criticisms have no foundation, legal or otherwise, and certainly have no place in a study which purports to be conducting a serious analysis of mortgage market integration.

B.) Positive findings of the study

Some of the findings of the LE study could however be welcome, for example:

1. In favour of market driven approach and responsible borrowers

The study supports a market driven approach, arguing in favour of abolishing hard product restrictions (i.e. usury caps). The study also argues against the “Nanny State” so consumers are encouraged to be responsible about their lending decisions, provided adequate information is provided to them³³.

Regarding measures to reform consumer protection law, the study favours a “soft” approach and thus recommends the removal of “hard” product restrictions, i.e. statutory limits on interest rates, compulsory indexation or compulsory caps on variable rate loans. The “soft” consumer protection approach, according to the study, would permit wider product availability in many countries³⁴.

The study describes the effects of product restrictions among which are the fees for early repayment of loans. It is said that such restrictions are likely to reduce the amount of mortgage debt outstanding as lenders are prevented from making large or otherwise risky loans that some borrowers would like to contract³⁵.

2. Stressing the importance of proximity and physical presence in retail banking

The outcome of the lenders enquiry about banks’ interest in expanding their business to other Member States confirms that the preferred way to operate cross border is via opening subsidiaries in those markets where the foreign lender wants to operate due to the need for proximity to customers and better knowledge of the local markets via a physical presence³⁶.

³³ See page 20 of the study by London Economics “The costs and benefits of Integration of EU Mortgage Markets”, August 2005

³⁴ See page 76 of the study by London Economics “The costs and benefits of Integration of EU Mortgage Markets”, August 2005

³⁵ See page 145 of the study by London Economics “The costs and benefits of Integration of EU Mortgage Markets”, August 2005

³⁶ See page 62 of the study by London Economics “The costs and benefits of Integration of EU Mortgage Markets”, August 2005



Annex II - ESBG position on the 26th Regime (ESBG Position paper on the Green Paper on Financial Services (2005-2010), 1 August 2005).

Regime: need to clarify the concept and pros and cons of the Regime

To date, many parties across the financial services area have expressed themselves on their idea of a 26th Regime, and it seems clear that there are as many interpretations as there are expressions of views on the topic. For this reason, the ESBG is very much in support of advancing thought on this issue by formalising the debates at the European level in order to arrive at a mutual understanding and definition of the concept. This should also include the consideration of theoretical applications of possible targets under such a regime. The ESBG would be keen to participate and contribute to such a task.

The ESBG wants to make clear however that before the results of such discussions has objectively clarified what is meant by a 26th Regime, all parties should pronounce themselves with caution on the potential benefits of such a system. In addition, a preliminary ESBG assessment of the pros and cons of a 26th Regime, as ESBG understands it, leads us to the belief that it should neither be seen as a panacea to the problem of harmonization, nor as an alternative to targeted harmonization, but as an option that may have certain applications, in certain circumstances.

The idea of a ‘26th Regime’ was put forward in September 2004 as a proposal by the European Financial Services Round Table to harmonize pensions products³⁷. Their proposal is to create a separate pension structure which would operate alongside and complement existing national pension structures, which would be left undisturbed.

“The basic principles underpinning the creation of the stand-alone or ‘26th regime’ structure include agreement by Member States on a single set of autonomous rules for pension solutions that would apply uniformly throughout the EU”³⁸.

This regime should be seen as an alternative to existing partially harmonised, national legal provisions, although many points of detail and in particular the relationship to national legal systems, still require clarification.

The 26th regime would recognise the existence of 25 different national regimes in the EU member States and would entail to establish a 26th regime, which would be optional, i.e. economic actors that are interested in EU wide operations could opt-into this EU regime (and thereby implicitly opt-out of their “national” regime).

It needs then to be decided whether a 26th regime will only be applicable to cross-border products, or whether it would also apply to products offered by a given provider in his home country. Applying it both at home and in a cross-border context would make more sense, as it is hard to imagine a bank developing a product which it will be able to supply in all markets except its domestic market.

³⁷ “Creating a common structure for pan-European pensions”, September 2004, European Financial Services Round Table.

³⁸ Idem.



The advantages of such a system, as far as the ESBG can see them, are as follows:

- It would allow providers of financial products who wish to offer products in several Member States to do so while not impacting those providers who wish to continue to operate only locally with any extra regulation.
- It gives consumers a choice between obtaining a product from a local provider offering products compliant with all national requirements or to utilise a new Pan-European product.
- It allows the development of a new, separate, legal framework, while avoiding having to reform existing domestic legal frameworks, which continue to exist in parallel.

Such a system also has disadvantages however. According to the ESBG, they are the following:

- If a 26th opt-in regime is created, which would be available for all providers of financial services, independent of whether they offer their services cross-border or exclusively within their country, it would necessitate specific EU legislation. This would most likely require regulation at the top level, i.e. combining the consumer protection levels of all Member States, as it seems very unlikely that a Member State would agree to such an alternative opt-in regime being lower than national provisions and therefore resulting in a flight of all national actors from the national regime into the opt-in regime.
- The 26th regime might open the door to EU wide product standardisation. These standardised products would most likely not reflect the economic realities / demand profiles of country-specific markets and these would be available at a premium cost to normal products given that they would have to reflect the highest consumer protection laws of the 25 Member States to receive approval by all Member States.
- Adjusting the national system interfaces with the 26th regime (for instance civil and procedural law) would be complicated.
- With the introduction of the 26th regime consumers will be confronted with two different legal systems – the “European” and the national one. This will not only create problems for the consumer, who has to decide which product and “regime” is more ideal for his needs, but also for banks in terms of providing advice (e.g. could a bank still offer products with a “lower” legal protection scheme without running liability risks?).
- If the 26th regime would only apply to cross-border operations, it could result in the creation of a two-tier regulatory system, creating an un-level playing field between those banks who operate exclusively in the “national” or the “European” regime respectively, while both will be competing on the same market for the same customer.
- Assuming that such a 26th regime is created at EU level as an opt-in regime, there is a risk that it might not be used due to the high protection level. What will happen then?
- It is not yet clear in which areas a 26th regime could provide added value: consumer law, prudential supervision, taxation, redress, others? Current pilot-projects are



foreseen in the area of pensions (EFR) and for mortgage collateral (follow-up to EC Forum Group Mortgage Credit).

An ESBG assessment of the introduction of a 26th regime leads therefore to the conclusion that it would, on the one hand, generally leave existing national regulatory systems untouched and might provide a suitable tool for internationally active banks which request standardisation across countries to achieve economies of scale. Many questions surrounding the establishment of a 26th regime are as of yet however unanswered. This adds a layer of abstraction in the current debate which increases the need to be cautious about any assessment at this stage.

On the other hand, the creation of a 26th regime might result in the highest levels of regulation, the application of which would neither be in the interest of banks nor consumers. Finally, the introduction of an opt-in system could be a first step towards a two-tier regulatory system, which is in direct contradiction with the principle of “same business, same risks, same rules” governing EU financial services regulation so far.



ANNEX III - The risks of developing a pan-European secondary mortgage market: the hedging of mortgage-backed securities in the US

Back in the summer of 2003, a 20 year bull market in American Treasury bonds came to an abrupt end. This followed a smaller-than-expected cut in short-term rates at the Fed's June meeting, and relatively positive comments by Alan Greenspan on the notion of a US recovery. A large sell-off in bonds promptly followed, leading to sharp falls in bond prices and a consequent sharp rise in yields not seen in two preceding decades.

This sudden and important rise in yields was alarming, for the belief then was that the event on its own could jeopardise the recovery that was hoped for as a result, primarily, of the expected reduction of mortgage refinancing – thereby cutting off a primary source of consumer spending.

The exact causes of that sell-off weren't clear. What was clear however, is that two events were most likely to have triggered it: the Fed's actions and comments by Greenspan, which gave the markets an impression that the Fed expected that a recovery was on the way, and forced selling by holders of mortgage-backed securities.

Mortgage-backed securities account for about a third of the American bond market, making them the biggest segment, and the belief is that the large role played in the market by mortgage-backed securities exacerbated the sell-off. This is due to a particular characteristic of MBS, which distinguishes them from other bonds, that of prepayment risk, which is the risk that mortgages will be paid back early as yields fall. One natural hedge against this type of risk is in fact to hold other bonds, like Treasuries, which do well when yields fall. But of course in June 2003, yields were rising and this gave rise to a large sell-off of Treasuries by holders of MBS.

And also, the sharp increase in yields was bad for both Fannie Mae and Freddie Mac, as it lead to an increase in their funding costs and the likely fall in refinancing would lead to a fall in their revenues.

As we know today, the US recovery was sustained in spite of these events in the market, but this is less due to the fact that the fears about the severity of these events was overdone, and more to do with a combination of macroeconomic factors that have supported the US recovery, not least the maintenance, to date, of low short-term interest rates as well as a huge fiscal stimulus combined also with a significant fall in the value of the dollar. But we have yet to see what happens to the US economy when the Fed starts putting up interest rates again, and a great concern on Mr Greenspan's agenda will be not to risk triggering a repeat of what happened in the summer of 2003, given the Chairman's recognition of the importance of consumer spending as a vital prop for the American economy over the past couple of years.

This illustration serves to point out that facilitating the development of a large, secondary market for securitised bonds in Europe might risk eventually leading to the replication of a situation such as that in the US, where the actions of holders of instruments such as mortgage-backed securities have that much influence on the economy.



About ESBG (European Savings Banks Group)

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of €4,345 billion (1 January 2004). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG members are typically savings and *retail* banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their *region*. For decades ESBG members reinvest *responsibly* in their region and are one distinct benchmark for corporate social responsibility activities throughout Europe and the world.



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