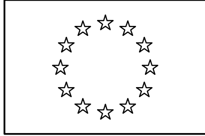

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Accompanying document to the

White Paper on the Integration of EU Mortgage Credit Markets

Summary of the Impact Assessment

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SUMMARY

Disclaimer

This impact assessment report commits only the Commission's services involved in its preparation and the text is prepared as a basis for comment and does not prejudge the final form of any decision to be taken by the Commission.

1. INTRODUCTION

Mortgage credit linked to a house purchase is, for most EU citizens, the biggest financial investment of a lifetime. EU mortgage credit markets represent a significant part of Europe's economy, with outstanding residential mortgage credit balances representing almost 47% of the EU GDP[1].

Completing the Single Market in financial services is an integral part of the Lisbon economic reform process; and essential for the EU's global competitiveness. However, although significant progress has been made in constructing a Single Market for financial services, retail financial services integration has not yet reached its potential. Competition in some markets is insufficient, leaving EU consumers and mortgage lenders unable to take full advantage of the benefits of the Single Market. In this respect, this impact assessment should be placed against the background of the White Paper on Financial Services 2005–2010[2], the results of the sector inquiry into retail banking[3], the Green Paper on Retail Financial Services[4] and the Communication on a Single Market for 21st Century Europe[5].

For several years, the Commission has engaged in a comprehensive review of EU residential mortgages markets. This review covers credit agreements secured by a mortgage or by another comparable surety commonly used on immovable property as well certain credit agreements the purpose of which is acquiring property rights. The focus is on residential mortgages, but it may have implications, in a few instances, for commercial mortgages.

The Commission's policy decisions are presented in a White Paper on Mortgage Credit. In line with the better regulation principles, any policy orientations are carefully considered and their impact thoroughly assessed beforehand. Accordingly, an impact assessment has been prepared, which is based on the results of a series of consultations and studies over the period 2003–2007[6]. This impact assessment identifies the problems in EU mortgage markets, sets out the Commission's objectives in the field of mortgage credit, considers the different policy options with which to achieve them, and assesses their potential impact.

Policy decisions presented in the White Paper will subsequently be further developed in close cooperation with all relevant stakeholders and will be subject to proportionate impact assessments before adoption.

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[1] *HYPOSTAT 2005: A review of Europe's Mortgage and Housing Markets*, European Mortgage Federation, November 2006, p. 140.

[2] COM(2005) 629, 5.12.2005.

[3] COM(2007) 33, 31.1.2007 and SEC(2007) 106, 31.1.2007.

[4] COM(2007) 226, 30.4.2007.

[5] COM(2007) 724, 20.11.2007 and SEC(2007) 1520, 20.11.2007.

[6] See Annex 2.

2. PROBLEMS IN EU MORTGAGE MARKETS

After a rigorous analysis of EU mortgage markets and taking into account the information collected through extensive consultations, a series of specific problems have been identified[7]. These problems fall into four general categories: obstacles to the cross-border supply of mortgage credit, limited product diversity, low consumer confidence and restricted customer mobility.

2.1. Obstacles to cross-border activity by mortgage lenders

Differing regulatory and consumer protection frameworks, fragmented infrastructures and different mortgage funding frameworks, create legal and economic barriers, restricting market entry and the development of efficient mortgage financing strategies. The result is limited product diversity and higher prices for consumers.

Economic barriers (e.g. the costs of accessing infrastructures and the need to adapt products, business models and pricing strategies) raise the costs of doing business in another Member State. Economic barriers also raise the cost of financing mortgage loans for mortgage lenders, thus reducing the opportunities for economies of scale and deterring mortgage lenders from using capital market mortgage financing instruments. These barriers deter market entrants, limit competition and push up prices for consumers.

Legal barriers may prevent or complicate the offering of certain products or accessibility to market infrastructures, limiting competition and stifling innovation. In some countries, some mortgage lenders are unable to do business at all. Many of these legal restrictions, which exist to protect consumers or the financial stability of the mortgage lender, may indirectly limit consumers' access to a mortgage loan. Legal provisions or the lack thereof in some Member States can also have a significant influence on the choice of funding techniques and thus on product diversity.

Specific problems, which restrict cross-border activity by mortgage lenders, have been identified in the following areas: pre-contractual information, early repayment, product tying, credit registers, valuation, forced sales procedures, land registration, applicable law, interest rate restrictions and mortgage funding.

2.2. Limited product diversity

A wide range of products is currently available on primary markets for borrowers in the EU. No single country, however, could be seen to have a complete range of products available either in terms of product characteristics or borrowers served[8]. This is due to several factors, e.g. consumer preferences and cultural differences and the fact that mortgage lenders may have different appetites for risk. This is however, also due to the existence of economic and legal barriers in some Member States which prevent mortgage lenders from offering certain products in certain markets or choosing their preferred funding strategy, restricting choice on the demand side and reducing competition on the supply side.

[7] See Annex 3.
[8] See Annex 1.

Specific problems, which limit product diversity, have been identified in the following areas: early repayment, interest rate restrictions, a range of mortgage funding issues, obligations to be a credit institution.

2.3. Low consumer confidence

EU consumers continue to predominantly shop locally for their mortgage products: virtually no EU consumers purchase mortgage products directly cross-border[9]. Although surveys indicate that the majority of consumers intend to continue to shop locally for their mortgages, a few would consider shopping around directly cross-border in the future[10]. This phenomenon can be attributed, inter alia, to two main reasons: a lack of consumer awareness of what exists elsewhere[11] and a lack of consumer confidence.

Insufficient or bad information, fears about whether legal rights will be upheld, or poor legal protection in the event that something goes wrong, as well as the need to function in a different language have all been cited by consumers[12] as factors which prevent them operating cross-border. Information asymmetries between the mortgage lender and borrower can also distort the market.

Specific problems, which impact on consumer confidence, have been identified in the following areas: pre-contractual information, financial education, product suitability, early repayment, and applicable law.

2.4. Restricted customer mobility

Customer mobility and the propensity of consumers to switch mortgage lenders can influence the level of competition in a market. The principle factors that influence mobility are twofold:

- Some consumers may prefer not to change their mortgage contract and thus will remain with their existing local provider.
- Consumers may face high switching costs. In some cases, consumers are not actually able to exit their mortgage contract due to restrictions. In other cases, the high costs of switching (e.g. early repayment charges and some administrative costs) or entering into a new mortgage contract (e.g. search costs) may outweigh the benefits.

Specific problems, which restrict customer mobility, have been identified in the following areas: pre-contractual information, early repayment, product tying, credit registers, and land registers.

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9 *Public Opinion in Europe on Financial Services*, Special Eurobarometer 230, August 2005, p. 39 and annex (Q4a). It should be noted that this figure excludes consumers purchasing a mortgage locally to finance a property abroad.

10 Cf. footnote 9, p. 42 and annex (Q4b).

11 *Internal Market – opinions and experiences of citizens in EU-25*, Special Eurobarometer 254, October 2006, p. 59 (QD16).

12 Cf. footnote 9, p. 47 and annex (Q4c).

3. THE CASE FOR ACTION AT THE EU LEVEL

According to the Treaty, an internal market is characterised by the abolition of obstacles to the free movement of goods, persons, services, and capital. The single market for residential mortgages is far from completion as obstacles of different kinds exist. These obstacles severely restrict the level of cross-border mortgage credit activity on the supply and demand sides, reducing competition and choice in the market. As a result, credit providers may be less efficient than they could be and borrowers face less competitive offers, a more limited product choice and some categories of borrowers may be marginalised or even excluded from this market.

Several studies[13] have concluded that there are benefits to be achieved through the integration of EU mortgage markets. One estimates that by 2015, over a period of ten years (2005–2015), the integration of EU mortgage credit markets could raise EU GDP by 0.7% and private consumption by 0.5%. The net present value of all costs and benefits of new initiatives are estimated by the London Economics study over a ten year period (2005-2015) to be EUR 94.6 billion or 0.9% of EU GDP in 2005[14]. Another puts the benefits of improving the efficiency and completeness of EU mortgage markets per annum to be equivalent to 0.3–0.6% of EU residential mortgage balances, equivalent to 0.12–0.24% of GDP in 2003[15].

Some of the more intangible factors to the cross-border provision of mortgage credit, such as language, distance, consumer preferences, or mortgage lender business strategies, cannot easily be addressed by the EU. However, other factors which prevent the conduct of business or substantially raise the cost of business for offering or taking out a mortgage credit in another Member State can be addressed by appropriate EU policy initiatives.

4. POLICY OBJECTIVES

To address the problems identified, four general objectives have been set[16]:

- to facilitate the cross-border supply and funding of mortgage credit by removing the barriers and reducing the costs of engaging in cross-border activity in order to ensure open markets and strong competition;
- to increase the diversity of products that meet consumers' needs by removing barriers to the distribution and sale of products, including innovative and new products across Europe;
- to improve consumer confidence by ensuring that consumers are empowered to make their own decisions and benefit from a high level of protection;

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13 See for example, *The Costs and Benefits of Integration of EU Mortgage Markets*, London Economics, August 2005, p. 5; *Study on the Financial Integration of European Mortgage Markets*, Mercer Oliver Wyman and the European Mortgage Federation, October 2003, p. 5; *Risk and Funding in European Residential Mortgages*, Mercer Oliver Wyman and the Mortgage Insurance Trade Association, April 2005, p. 5.

14 *The Costs and Benefits of Integration of EU Mortgage Markets*, London Economics, August 2005, p. 5.

15 *Study on the Financial Integration of European Mortgage Markets*, Mercer Oliver Wyman and the European Mortgage Federation, October 2003, p. 5.

16 The specific objectives of individual measures are described in detail in Annex 3.

- to facilitate customer mobility by ensuring that consumers wishing to change mortgage lenders are not prevented or dissuaded from doing so by the presence of either legal or unjustifiable economic barriers.

Simultaneously achieving these objectives is not without its difficulties. Reconciling efforts to improve product diversity with policies to facilitate customer mobility and promote consumer confidence, for example, by ensuring an adequate level of protection, will present particularly difficult policy challenges.

5. ASSESSING AND COMPARING POLICY OPTIONS

5.1. Choosing the optimal policy mix

In order to establish the most appropriate policy response to meet the objectives set, a comprehensive analysis and comparison of different policy options has been conducted. For each problem identified, a mix of policy options from the following range has been considered: do nothing; develop a 'scoreboard'; issue guidelines; publish a Recommendation; encourage self-regulation; enforce existing EU legislation; present new legislation. Some options have been dismissed as being unrealistic or obviously cost ineffective. In other areas (e.g. interest rate restrictions, transferability of loan portfolios, residential mortgage backed securities and the issue of non-credit institutions) it is clear that further analysis needs to be undertaken before any meaningful policy options can be proposed.

For all credible options, the impact was carefully and thoroughly assessed, taking into consideration the positive/negative and direct/indirect effects. The main criterion used to compare the options is the effectiveness of each option in terms of achieving the objectives set. In addition, other aspects such as the efficiency of each option and their impacts on different stakeholder groups were taken into account where sensible at this stage of the review. On the basis of this assessment, ineffective policy options have been dismissed. The impact assessment identifies a package of the most effective policy options which would contribute to achieving the objectives set. For several subjects, a series of complementary measures are deemed appropriate.

The impact assessment concludes that **legislation** is the most effective policy option in several areas (e.g. pre-contractual information, product suitability, credit registers) and is the only effective option in some cases (e.g. Annual Percentage Rate of Charge – APRC), early repayment). However, although legislation would be the <u>most</u> effective option in terms of achieving the set objectives, whether the costs of implementing legislation outweigh the benefits is still to be assessed. This is particularly important for areas such as pre-contractual information and product suitability, where self-regulatory action could also potentially be effective albeit to a lesser extent but could be more cost efficient. The same applies to APRC and early repayment where legislation is deemed the best option. Consequently, a more in-depth quantitative impact assessment is required to establish whether legislation or self-regulation is the most efficient solution. **Self-regulation** is also identified as an effective policy option in its own in other areas (e.g. credit registers, mortgage funding reporting).

The impact assessment concludes that non-binding measures such as the publication of a **'scoreboard'** (e.g. forced sales procedures, land registration) and a **Recommendation** (e.g. property valuation, forced sales procedures, land registration) can offer an effective solution to the problems identified. The **enforcement of existing EU rules** is also envisaged

for several areas (e.g. credit registers, covered bonds). In several areas (e.g. applicable law, Basel II, financial education, house price indices), **existing EU policies** were identified as being designed to address the problem identified. Finally, the impact assessment also recommends that for certain specific problems in the area of covered bonds and residential mortgage backed securities, **no action** is required.

5.2. Impact on stakeholders

The impact of the package on **consumers** is direct and indirect. In terms of indirect impacts, many of the measures to improve the efficiency and competitiveness of cross-border mortgage lending – both on primary and secondary markets – would lead to improved product diversity and, potentially, lower prices for consumers.

Increased customer mobility, as a result of several policy options (e.g. information, credit registers, product tying) should also create a more competitive environment and generally lead to price reductions. In terms of direct impacts, the focus is on ensuring that consumers purchase the most appropriate mortgage credit product for their needs, thereby improving consumer confidence. This materialises in the form of better information, advice, and creditworthiness assessments. By choosing the most appropriate product for their needs, the risk of consumers losing their home would be minimised. At the same time, these measures will translate into higher costs for mortgage lenders and therefore have a negative impact on the price of mortgage credit and, to a lesser extent, on product diversity. While the net impacts are difficult to assess in quantitative terms, the overall benefits are seen to be positive.

For **mortgage lenders** the package has both costs and benefits. Benefits can be realised through a more efficient mortgage lending process which would lead to lower costs: reduced costs for refinancing costs, land registrations and credit information access. Mortgage lenders are also likely to benefit from enhanced transparency in several areas (credit registers, land registers, forced sales procedures, house price indices). In addition, the ability of mortgage lenders to access other markets and engage in cross-border activity would clearly be enhanced, offering opportunities in terms of new business. While the package offers benefits for mortgage lenders, the cost of implementing these measures should not be underestimated. Back-office procedures will have to be amended and compliance ensured. It should however be emphasised that those measures which bring the highest costs to mortgage lenders are the same measures which bring the most benefits for consumers.

Investors would face a lower risk when investing in mortgage backed products as a result of several factors. First, enhanced market transparency would facilitate the assessment of the risks connected with the product and enable more accurate comparisons between different mortgage backed investment products. Second, in the event of default, investors would have greater certainty as to the recovery value of their investment. Finally, investors would also be able to benefit from a broader range of investment opportunities as a result of enhanced product diversity both on primary and secondary markets.

The costs for **Member States** fall broadly into two categories: costs of implementing legislation and recommendations, and costs for compiling data for scoreboards and house price indices. The level of costs depends on the extent to which Member States already have similar legislation or processes in place. Costs to Member States for implementing legislation can be minimised by choosing the self-regulatory options over the legislative ones. However, as described above, opting for self-regulatory measures involves a trade-off with policy effectiveness, unless subscription and adherence to self-regulation can be ensured with

appropriate enforcement mechanisms. If the enforcement mechanisms were potentially run by Member States, costs would also be incurred. A detailed quantitative impact study would be required to fully assess the net impact of self-regulatory measures when compared to legislative options on the different stakeholders before a final decision could be taken.