

EU MORTGAGE MARKET INTEGRATION

Summary: Mortgages are of paramount importance in developed economies and financial systems, as a means towards homeownership and also as one of the main channels through which monetary policy is transmitted. The Kok Report¹ urged Member States to 'unleash the dynamism of financial markets' and in particular it called for a 'reduction in the restrictions to more flexible mortgage financing in a number of Member States'. The integration of the European mortgage markets is considered a cornerstone in the process of European retail financial market integration which could bring benefits for customers and financial institutions. However, local specificities prevent an integration of the market in the short run. When seeking to overcome the barriers to integration, it is generally recognized that policy makers should avoid product harmonization that would lead to a reduction of the range of products currently available. Some efforts to improve transparency in the market have been carried out through the implementation of the voluntary Code of Conduct on Home Loans which standardizes information for consumers. The European Commission recently released a Green Paper on Mortgage Credit and a Report on costs and benefits of further integration in the EU mortgage market.

Mortgage credit relevance in the EU Economy

The provision of housing is one of the main concerns of every society. The purchase of a home is the biggest investment decision which households will make, and together with pension funds, homes represent the most important asset of a household's wealth. The existence of a dynamic and efficient mortgage market is a prerequisite for housing market development both to create the supply and to generate the demand. The primary function of mortgages is to allow households to receive advances today based on their future income and secured by the borrower pledging his property. The safety provided by the collateral means banks are able to lend with confidence and with lower loss experiences. The borrower benefits through lower rates and greater access to finance. Additionally another important function of mortgages is to allow the borrower to unlock capital in the home to invest in a business, to finance consumption or provide an income in old age.

In the last two decades, the development of mortgage markets has significantly improved housing affordability. Macroeconomic and financial stability in the European Union paved the way for an important increase in the stock of credit for house purchase which at end 2004 represented around, €4.7 trillion, equivalent to 45% of Europe's GDP. The Financial Services industry has embraced technological innovations which have allowed it to manage the risks in loan portfolios much more efficiently. These advances have meant that lenders have been able to expand into new markets which previously would have been seen as too high risk. Better information management, the expansion of amortization periods and more risk based pricing have increased the number of households with access to the mortgage market. All of these improvements have been reflected in home ownership ratios, which have risen in most developed countries (between 1983 and 2003, homeownership in Europe rose from 57% to 64%²).

The relevance of mortgages in the European economy is also related to their role in economic policy management. Housing loans are one of the main channels through which monetary policy is transmitted. For this reason, the design of an efficient mortgage framework is a positive externality for the economy as a whole.

The relevance of mortgages in the financial system has also been increasing in recent years. Loans for house purchase alone represent 33% of banking exposures excluding loans to financial institutions. Given the low risk profile of mortgages, there are important positive externalities for financial stability and systemic risk. These facts were recognized by the Basel Committee on Supervision when drafting the new rules on capital adequacy. When the new rules come into force, in 2007/2008, mortgage credit will be one of the main beneficiaries in terms of the amount of capital which has to be held to guard against unexpected losses.

¹ "Facing the Challenge – The Lisbon Strategy for Growth and Employment", Report by the High Level Group chaired by Wim Kok, November 2004

² Source: European Mortgage Federation calculation based on EU12

The Costs and Benefits of an integrated mortgage market

Given the importance of mortgages in the EU economy, the integration of the European mortgage market is considered a crucial part in the process of European retail financial services integration bringing important benefits both to consumers and financial institutions. A study by London Economics³ looking at the cost and benefits of mortgage market integration points towards clear benefits for Europe's economy. The benefits are estimated at 0.89% of GDP for the period 2005-2015 assuming a fully integrated market. This would entail full product availability at the same level in each member state and a lowering of mortgage rates in all member states to be in line with the lowest currently available.

The benefits on the consumer side can be summarised as:

- Consumers will have access to a wider product range. As the Mercer Oliver Wyman study⁴ shows, product variety and the range of distribution channels are very limited in some Member States. In contrast, product variety on a European basis is very rich as a result of the differences in mortgage market infrastructure. In this respect, it is advisable to avoid regulations aimed at harmonising product characteristics to the detriment of the supply of products currently available.
- Competition in local markets has proved to be a very significant issue encouraging efficiency gains and pushing prices down. In this sense, further integration of the European mortgage markets would have a positive impact on housing affordability, especially in countries where competition is lower.

The benefits on the industry side are:

- The ability to grant loans in a larger more liquid market presents important benefits for the risk profile of financial institutions. Divergences in European housing cycles could significantly reduce market risk allowing a healthier diversification of the mortgage portfolio.
- Fostering competition between EU financial institutions would encourage efficiency improvements that will contribute to create a sounder European financial system. This could be through economies of scale as the markets expand or more innovation and spreading of best practices.
- Finally, further harmonization could favour the creation of a deeper and more liquid secondary market in mortgage debt which would reduce the funding cost for mortgages and thereby possibly mortgage interest rates.

The costs of integration will depend on the measures used to achieve the single market, but will largely be the costs associated with complying with new regulations, such as staff training, legislative process, technology changes, etc. Overall London Economics estimate the cost of integration at €2.5bn a year equivalent to 0.02% of GDP.

Domestic factors preventing the integration of the mortgage markets

The current framework of mortgage markets in Europe has historically evolved in line with the domestic regulatory environment and the population preferences regarding housing tenancy. The adoption of the euro and the fall of barriers to entry in the financial business promoted by the EU regulation have not modified these domestic specificities, with mortgage markets remaining extremely fragmented.

Some examples can give an idea of this heterogeneity. First, although it is difficult to measure it precisely, dispersion of housing transaction costs between European countries is still important, ranging from around 17% in Belgium, down to below 2% in UK. Second, terms and conditions of mortgage loans are very different. According to the ECB at the end of 2004 the share of mortgages where the interest rate is fixed for at least ten years was around half of the total outstanding mortgage in the euro area, but this proportion varies widely from country to country. Belgium, Germany, France and the Netherlands are countries where fixed-interest rates are dominant, while in other markets such as the UK and Spain variable rates prevail. Third, as the Report of the Forum Group of Mortgage Credit⁵ points out, different regulatory aspects (constitution and registration regimes and

³ "The Costs and Benefits of Integration of EU Mortgage Markets", London Economics, August 2005

⁴ "Study on the Financial Integration of European Mortgage Markets", Mercer Oliver Wyman for the European Mortgage Federation, September 2003

⁵ "The Integration of the EU Mortgage Credit Markets", Report by the Forum Group on Mortgage Credit, December 2004.

costs, property valuations, forced sales procedures or credit registers) are key in limiting integration in the short run, i.e. in preventing lenders from going cross-border.

However, probably the largest barrier preventing lenders crossing borders remains the low level of profitability of the mortgage product in some countries. In some countries competition is such that mortgages are sold at a loss with revenue being generated through the sale of other products such as insurance or credit cards. Combining this low profitability with the extra costs of breaking into a new market, really explains why so little cross-border business has taken place to date. But economies of scale allowed by a deeper integration of European markets could improve cost efficiency and therefore profitability.

Consumer protection: the Voluntary Code of Conduct on Home Loans

In addition to these supply factors, it is important to consider that there are also some barriers for consumers in order to obtain a cross-border mortgage. First, lenders would not be ready to grant a loan to a consumer established in a country where he has no infrastructure because of the increased risk due to the lack of knowledge of the market. Second, this is also due to the fact that mortgages are linked to the property which itself is regulated by the legislation of the country where it is located. Third, it can be difficult for a consumer to make an informed choice between different mortgage products that are covered by different legislation and are offered in different languages. In these circumstances, the lack of interest of the European consumer on cross-border mortgages is understandable. According to the Eurobarometer survey, only 5% of consumers across Europe would consider buying a mortgage in another EU country in the next five years. Most of these consumers are executives, whereas only 1% of house persons and retired consumers would consider looking for a mortgage abroad. However in contrast to these findings London Economics have undertaken their own survey which confirms that if the lender comes to the borrower and offers a product under local terms and conditions with local consumer protection rules, consumers would not be deterred from changing to a foreign based provider.

In order to improve confidence in mortgage products offered by financial institutions across Europe, the Industry with the support of the European Commission promoted a Voluntary Code of Conduct which was fully negotiated and signed by both the mortgage-lending industry and the consumer associations in March 2001. The aim of this Code is to provide transparent and comparable information on housing loans offered throughout the Member States in order to facilitate cross-border competition. The financial institutions that have adopted the code should provide two sets of information. The first set covers general information on the different types of mortgages available. The second one consists of tailored-made information at a pre-contractual stage presented in a standard written format, known as a European Standardised Information Sheet (ESIS). The ESIS should include information about 15 items related to the product chosen by the client indicating, among other issues, the description of the loan, the amount, the nominal and effective interest rates, the term of the loan, the frequency of payments, the exact amounts to be paid over the time span of the loan, the possibility and conditions of early repayment, additional and extraordinary costs.

Currently financial institutions from 18 European countries have adopted the Code (the EU-15 minus Spain, Cyprus, Estonia and Hungary).

Future regulatory agenda

Mortgage markets remain unregulated by sector specific legislation at EU level. The Commission's FSAP did not include any measure on the mortgage market as such. The Commission released a Green Paper on the mortgage market in July 2005, which asks for stakeholders' opinions about all the issues that are currently being debated on the fields of consumer protection, legal issues, mortgage collateral and funding. This initiative, joined to the publication of a report about the costs and benefits of further integration, is part of the assessment that the Commission is carrying out to consider intervention in the market. The process will end in December with a public hearing to mark the conclusion of the Green Paper consultation period. The final policy recommendations will be included in a White Paper to be released in 2006.

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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