

## EPFSF Briefing: Mortgage credit

**Summary:** *The European Parliament is currently discussing the adoption of a report on the Green Paper on Mortgage Credit in the EU<sup>1</sup> which assesses the case for community initiatives aimed at further integration of European mortgage markets. There is evidence that national mortgage markets are already competitive and, therefore, efficient. Major gains for the European economy and consumers would result from increasing product diversity and competition in mortgage markets.*

*Therefore, market-led actions relying on product transparency and consumer information seem to be appropriate to unleash the benefits of an integrated EU mortgage market. A Code of Conduct<sup>2</sup> based approach, complemented by measures facilitating the ability of lenders to go cross-border and the creation of a liquid secondary mortgage and funding market, is most suited to reflect European mortgage market traditions and therefore requires further commitment.*

### Background

Mortgage loans outstanding at the end of 2005 are estimated at € 5.2 trillion or 49% of the EU's GDP<sup>3</sup>, having doubled in the last 10 years. Greater integration of EU mortgage markets could improve the competition, completeness and efficiency of national mortgage markets, impacting on consumer demand and the general economy via household spending. Lenders would realise economies of scale and opportunities for diversification which might result in greater choice and lower interest rates for consumers.

In March 2003, the European Commission set up a Forum Group on Mortgage Credit with a mandate to identify the barriers to the functioning of the Internal Market for mortgage credit. The Group drafted 48 recommendations to tackle these barriers, focusing on Consumer Confidence, Legal Issues, Collateral Issues, Distribution Issues and Funding.

In parallel, the Commission launched a research project, carried out by London Economics, on the cost and benefits of further integration of the EU mortgage credit market. While the report's assumption that greater competition and product completeness could bring significant gains to the EU economy, up to 0.89% of current EU GDP over the next ten years, should not be overestimated, given its methodological weakness, it is interesting to note that the report rejects a regulatory approach. In concrete terms, the report concludes that only an approach based on product diversity and availability will deliver the benefits of an integrated mortgage market, with transparency and consumer information playing key roles.

A wide ranging consultation process was initiated by the Commission's Green Paper in 2005. At present, two expert groups, Mortgage Funding Expert Group (with members drawn from consumer and industry groups), and the Mortgage Industry and Consumer Dialogue, are providing the Commission with further advice on funding and consumer specific issues. The Commission intends to publish a White Paper on Mortgage Credit on 31 May 2007 proposing concrete measures. The European Parliament is currently examining a report on mortgage credit at the ECON Committee (rapporteur John Purvis, PPE UK) and, regarding consumer aspects, at IMCO Committee (rapporteur Manuel Medina Ortega, PES ES).

### Results of the Green Paper consultative process

Contributors to the Green Paper consultation gave a clear message that integrating the EU market should not be to the detriment of national mortgage markets. Respondents also agreed that integration should not lead to product standardisation, and that the valuable diversity of mortgage products in Europe should not be sacrificed. Integration should not be pursued through product

<sup>1</sup> (COM (2005) 327) published by the European Commission on 19 July 2005

<sup>2</sup> "Code of Conduct on pre-contractual information to be given to consumers by lenders offering home loans", Commission Recommendation of 1 March 2001, published in OJ L 69 of 10.3.2001

<sup>3</sup> European Mortgage Federation Estimate

standardisation but rather through alternatives to regulation. Finally, according to contributions from all stakeholders, integration will be predominantly supply-driven rather than demand driven.

### **Characteristics of national mortgage markets**

Mortgage markets significantly differ between Member States, reflecting different social, cultural, legal and fiscal conditions. The range of products, distribution structures, loan durations and funding mechanisms also vary considerably. Strong competition has reduced mortgage lenders' margins so much that mortgage loans are often sold as products to attract consumers with very little or no return. There is evidence that the average price range of mortgages in the European Union is down to only 60 basis points. Thus, there is hardly any room for a further substantial decrease of mortgage interest rates for borrowers through more active cross border lending.

### **Competitive aspects**

The decision to grant mortgages to borrowers in other Member States depends above all on the ability of lenders to process this business and to be competitive on foreign markets. Successful cross border mortgage business depends on access to borrowers through distribution channels, access to land/mortgage and credit registers, and to information about the local real estate market. Property valuation, information about the quality of the mortgage collateral, the assessment of the borrowers' financial situation and other process-specific information and advisory services are further areas cross border lenders have to invest in. Increased costs for tailor made loan origination and administration as well as for external service provisions have to be factored into the mortgage interest rate. This has a negative impact on the ability of foreign lenders to compete against peers in the host countries, and can be seen as a barrier to entry into foreign markets.

### **Consumer concerns**

It remains uncertain whether individual consumers will shop for mortgages across borders, but increasing mobility of labour and citizens in Member States will increase their interest for non-domestic mortgage products. Mortgage market integration has to be conducted to the benefit of European consumers. Indeed, from a consumer perspective, the main benefits of a more integrated European mortgage market would be greater product choice.

Consumer confidence in new products and consumer information enabling them to make an informed decision are the key in this context. Information has to be comprehensive, focused on consumers' needs and delivered at the right time in the sales process. Information overload should be avoided. It is the concept of an educated and well informed consumer which has to underpin the mortgage market integration process.

### **Policy options**

Conditions for a supply-driven integration are the removal of barriers that prevent lenders from entering new markets and the implementation of measures fostering economies of scale.

If these barriers cannot be removed without having recourse to legislation, then targeted harmonisation (i.e. full harmonisation of key provisions such as pre-contractual information, APRC, right of withdrawal), should be considered as a means to increase integration of European mortgage markets. The principle of mutual recognition should be given due consideration in this context. However, targeted harmonisation should only apply to key elements deemed important for such an integration, and not result in product harmonisation that would lead to a reduction of the range of products on offer.

Measures should be taken to allow market forces to fill product gaps and act against market incompleteness. In line with the Commission's better regulation principle, any policy action should be proportionate, targeted and not hamper competition, mortgage products or funding techniques.

Thus, EU regulation in the area of mortgage prepayment and early repayment fees, which are core mortgage product features, could have a huge impact on finance techniques and systemic issues in Member States. Fixed rate mortgages provide protection against interest rate volatility and hence intrinsically fulfil core consumer protection purposes. In cases where early repayment is possible, the market should be left to decide whether the price for this right is implied in the interest rate

(embedded option) or charged at the moment of repayment (early repayment fee and only payable if right is used). This would give the customer the widest possible choice.

Comparability of mortgage and consumer information through the provision of a complete set of standardised information could be the main focus of further initiatives. This approach would involve the retention of the Code of Conduct on a self-regulatory basis and the improvement of its weight in the mortgage origination process, including the ESIS as a pan-European tool providing standardised, comparable and targeted information to consumers. APRC harmonisation would facilitate the comparability of products and add value to the integration process. The Code complements existing national regulatory regimes and practices and its non-statutory basis provides the necessary flexibility to respond to changing market and consumer needs.

European action could furthermore tackle structural barriers that hinder lenders operating across borders. This covers access to national land registers, to credit data, to information about improvements to the length of enforcement procedures in some Member States and repossession procedures.

Finally, the development of a liquid secondary mortgage market (such as the creation on a pan-European Securitisation market) could accelerate mortgage market integration. Cross border sales of mortgage assets and mortgage portfolio trading would favour risk diversification and the realisation of economies of scale. The same applies to mortgage funding. An efficient pan-European funding market would improve funding conditions and result in lower interest rates for mortgage borrowers. Hence secondary market and mortgage funding could be other priorities for action at EU level.

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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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