An Assessment of the Recommendations of the EU Forum Group on Mortgage Credit

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Introduction

In 2003 the European Commission set up the Forum Group (FG) on mortgage credit to foster consensus among stakeholders about the obstacles to a pan-European mortgage market and the steps necessary to aid its formation.

"The Integration of the EU Mortgage Credit Markets" was published in December 2004 as the final report of the group (the Report). [2] Following up on this document, the Commission in a Green Paper issued in July 2005 invited the general public to comment on its recommendations, raising in parallel a set of questions about the scope and type of possible policy initiatives.[3]

The FG was constituted among stakeholders in the European discussion, including consumer groups and industry representatives. It lies in the nature of such an approach that not all relevant stakeholders are represented and not all relevant issues are discussed. Still, the Report can be considered as a comprehensive attempt to address European mortgage market integration issues.

It makes 48 recommendations (henceforth FGR 1-48) to the European Commission concerning the five main themes of Consumer Confidence, Legal Issues, Collateral Issues, Distribution Issues and Finance.

The approach taken in this paper is to look at the set of recommendations from the perspective of whether they are individually and jointly conducive

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[2] Download from: http://europa.eu.int/comm/internal_market/finservices-retail/home-loans/index_en.htm#mortgage

[3] Green Paper on Mortgage Credit in the EU, July 2005, download from: http://europa.eu.int/comm/internal_market/finservices-retail/home-loans/index_en.htm#study

to mortgage market integration and enhanced efficiency and development of the national mortgage markets in Europe.[4] It argues that both, 'narrow' integration and 'broader' development perspectives, are needed for the proper evaluation of any EU policy menu. This contrasts with the constraints imposed on the EU Commission by the EU Treaty when making specific proposals, which generally have to focus on integration rather than development issues. That said, even a superficial review of the FG Report reveals that both perspectives have indeed been on the minds of stakeholders when formulating their recommendations.

The evaluation presented below takes a high level approach with regard to the entire set and subgroups of FG recommendations by commenting on the approach and doing a broad assessment, while discussing empirical studies and commenting in detail only for selected areas.

The paper starts by examining the Forum Group's approach to consumer protection. To better structure the discussion and in line with standard legal and economic review, the section has been split in two - consumer information and counselling, and material consumer protection/product harmonisation. After that issues of property law, valuation standards and other collateral issues, as well as the secondary mortgage market are discussed. Drawing on the Forum Group's recommendations, the section concludes with list of measures that the author believes will be pivotal for the creation of an integrated mortgage market in the European Union.

Consumer information and counselling

Consumer information vs. material consumer protection – the antagonistic debate

It is conceptually important to differentiate in the evaluation between the two traditional areas of consumer protection policy: consumer information and counselling, and 'material' consumer protection.

On a time scale of the mortgage financing, the first area affects mainly the interactions between consumers and lenders prior to and at contract signature, while the second affects the going concern of the contract and the process of execution.

Another typical delineation considers as a legal benchmark the principle of contractual freedom: here 'material' consumer protection measures are defined as those restricting the menu of contractual rights (obligations) and obligations that lender and consumer may agree on.

4 Occasionally, where central issues were not covered by the Forum Group, reference is also made to EU regulatory proposals that are under discussion. An example would be the Consumer Credit Directive (CCD).

Forum Group approach

Consumer information and counselling rules try to deal with two major sources of information imbalances that affect the search and contract negotiation phase: information asymmetry and consumer heterogeneity.

The mortgage market may be seen a 'textbook case for market failure caused by information asymmetry. One party is in the market continuously, the other very infrequently – sometimes only once or twice in a lifetime.[5] Market failure due to information asymmetry has thus been a consensus intervention ground, and mandating disclosure from lenders to consumers a consensus response.

Disclosure is consequently a strong focus of the FGR. Moreover, it is an area characterized by relatively far-reaching agreement:

- FGR 3,6, 9 and 14 take broadly consistent perspectives of the European Standardized Information sheet. The main disagreement between consumer groups and lenders is whether the pre-contractual information standards of the ESIS should be rendered mandatory in the entire EU.
- FGR 5 establishes a broad agreement on the usefulness of operating with an annual percentage rate (APRC) concept. However, FGR 11 and 16 generate dissent by demanding either a narrow or a broad definition of APRC.
- In FGR 8 consumer groups also call for a broad standardisation of mortgage contracts, which is contested by lenders. The 2002 CCD proposal broadly took the consumer groups' view by detailing several lending cost concepts and requiring standardised contracts.

A more contested area still is whether and how consumer heterogeneity, implied by consumer characteristics or lack of financial literacy should be addressed by consumer protection regulation. The EU debate is also deeply split on the issue.

- FG 9 calls for a regulation requiring lenders to give the best possible advice, reflecting the 'demands and needs' of the consumer.
- The 2002 CCD proposal formulated in Article 6 a lender duty to give the best possible advice and in Article 9 a duty for responsible lending, which entails that a borrower's overall financial circumstances are taken into account.

Both points seem to be universally rejected by lenders.[6] Another route of addressing consumer heterogeneity taken in the 2002 CCD proposal, requiring member states to set up positive consumer databases in order to

[5] Guttentag (2002).

[6] For a recent statement, see EMF (2005).

identify financially overstretched borrowers, has in the meantime been dropped in favor of a call to 'open up' existing databases on a non-discriminatory basis (see also below).

Table 1: Assessment of Forum Group Recommendations 1 – 18, Consumer Confidence

	Forum Group Recommendation	Type	Stakeholder Positions	Benefits for Integration	Benefits for Domestic Efficiency	Implementation Costs	Benefit/Cost Relation
	INTRODUCTION						
1	Monitor cross-border lending	Public good	Agreement	Low	Low	Moderate	Moderate
	CONSUMER CONFIDENCE						
2	Study integration costs/benefits	Study	Agreement	Low	Low	Low	Moderate
3	Encourage use of ESIS	Public good	Agreement	Moderate	Moderate	Low	Moderate
4	Harmonize early repayment fees	Regulation	Some disagreement	High	High	Moderate	High
5	Harmonize APRC (general principle)	Regulation	Agreement	High	High	Moderate	High
6	Study ESIS value for consumers	Study	Agreement	Low	Moderate	Low	Moderate
7	Online guide cross-border lending	Public good	Agreement	Low	Low	Low	Moderate
8	Standardized contract formats	Regulation	Disagreement	Moderate	Low	High	Low
9	Counseling duty for lenders	Regulation	Strong disagreement	Low	Low	High	Low
	Consumer right to redress	Public good	Disagreement	Low	Moderate	High	Low
	Make ESIS mandatory	Regulation	Disagreement	Low	Moderate	Low	Moderate
10	Universal prepayment option	Regulation	Some disagreement	High	High	Moderate	High
	Limit to 'first few years'	Regulation	Strong disagreement	Low	Low	High	Low
	Subject to statutory ceiling	Regulation	Strong disagreement	Low	Low	High	Low
	Precontractual indication	Regulation	Disagreement	Moderate	Moderate	Low	Moderate
11	Harmonize APR w broad definition	Regulation	Disagreement	High	High	High	Moderate
12	Ensure consumer redress & enforcement at highest level	Public good	Disagreement	Low	Moderate	Moderate	Moderate
13	Exclude secured loans from CCD	Regulation	Strong disagreement	Low	Low	Low	Low
14	Align national rules to ESIS, if existent	Regulation	Disagreement	Low	Low	Low	Low
15	Keep ESIS Code of Conduct approach	Regulation	Disagreement	Low	Low	Low	Low
16	Harmonize APR w broad definition	Regulation	Disagreement	High	High	High	Moderate
17	Remove legally enforceable interest rate caps	Regulation	Strong disagreement	High	High	High	Moderate
18	Full compensation for losses from early repayment	Regulation	Strong disagreement	High	High	Moderate	High

Source: European Commission (2004), author's assessment.

Selected issues

Annual percentage rate of charge (APRC)

Issues and evidence

The APRC is central to the concept of disclosure. It is defined as the internal rate of return of future payment streams from consumers to lenders. There are various conceptual problems with APRC in mortgage finance:

First, such a computation assumes a constant duration of the loan and invariability of loan terms over time. Unfortunately, since mortgages are prepayable and often priced at variable rates or rates reset periodically, both assumptions are violated as a rule than as an exception.

Consider a standard variable rate loan with a 2-year initial period of low fixed rates ('teaser'). This is the most popular loan product in the UK and gaining in popularity in the US ('hybrid' ARM). For such a product, taking the APRC over the fixed-rate period is misleading - it is known in advance that rates will not remain constant, but it is unknown how they will develop.

Even the concept of an 'initial' APRC - comparing the teaser rates only – is misleading, since the lender can 'claw back' any discount by a certain amount of overcharging in the variable rate loan phase.[7] In contrast, so called 'tracker' ARMs following an inflation index with constant contractual spreads can be compared with relative ease.

As a second example, compare the typical US product, a 30-year prepayable fixed-rate loan, with the typical German product, a 10-year fixed-rate loan with prepayment indemnity or exclusion. Since US borrowers frequently exercise the prepayment option, the effective duration of a US loan is between 4 and 7 years, after which a new loan is closed. In effect, the German loan has therefore a longer duration than the US loan; closing costs will be amortised over longer periods, which leads to distorted APRC results.[8]

Other products, such as German *Bausparen*, require pre-savings at below-market rates and thus contain elements of cross-subsidisation that are not captured when looking at loan durations only.

These examples show that APRC comparisons in mortgage finance only make sense if product idiosyncrasies, including borrower and lender options, are taken into consideration. In other words, APRCs should be used to compare only sufficiently similar contract classes. This requires product classification prior to establishing computation rules.

In contrast, the discussion both in the Forum Group and surrounding the CCD reform proposal has centred on computation, especially on which costs components ought to be included, as well as on mathematical details.

Clearly computation methods vary considerably across countries, which suggests a need for harmonisation. In France, all third-party costs required by the lender need to be included in the APRC, while Germany and the UK use much narrower concepts. However, it should be added that the range of mandatory services or third-party services intermediated by the lender is broad, too, and typically highly idiosyncratic for a national market. An example is the distribution of value-added between different service providers in the UK, where mortgage insurers providing third-party cash flow insurance and other products generate higher gross value-added than the mortgage industry itself.[9]

Regulation options

Mortgage loans have to be classified prior to applying an APRC concept. The reason is simple: stating a price without describing the product offered for the

[7] In the UK, for example, lenders decide only shortly before the end of the teaser period which standard variable rate offer to make to a particular customer.

[8] For a computation example, see Dübel, Lea and Welter (1997).

[9] In that regard, kickbacks between lenders and third-party service providers are an issue, which has been addressed by corresponding regulation in the US

price does not allow for meaningful comparisons domestically, let alone between heterogeneous product classes internationally.

Conceivable product classes would be reviewable-rate mortgages, index-tracker mortgages, short-term/reset non-callable fixed-rate mortgages and mortgages fixed to maturity with prepayment option. In any case, APRC concepts should use expected, rather than contractual duration measures to come to economically meaningful result. In that regard, a harmonisation of early repayment fees would in fact also support harmonising APRCs, since it would permit a comparison of durations of prepayment protected ('non-callable') fixed-rate mortgages across Europe.

Still, product subclasses would have to be differentiated with regard to interest rate caps, prepayment indemnity formulations, pre-savings requirements, other consumer options (e.g. portability to a different house), etc. If necessary, specific options costs or idiosyncratic cost components could be 'stripped' or cost components merged in order to reach comparability – an example are *Bauspar*-loans, where both below-market savings and credit guarantee can be priced with mathematical methods and included into an APRC concept for the entire financing.

The debate about narrow and broad APRC ambits has been addressed in the 2002 CCD proposal and reflects a recommendation given by Dübel, Lea and Welter (1997) to use both concepts. The CCD proposal differentiates between the two concepts of total lending and borrowing rate (Articles 13 and 14). In that regard, the argument behind FGR 16 brought by the lenders that 'additional elements could vary from one member state to another' is both true and tautological. The formulation of Article 13 CCD proposal requiring calculation of the total lending rate including all charges levied by the creditor but excluding taxes and fees for optional or non-creditor-related services in contrast appears reasonable. In advertisement practice it is likely that the borrowing rate will play the most dominant role, adding a total lending rate in that regard will create an additional attention burden on the consumer. At the same time it will be an important reminder of additional costs incurred when agreeing on a mortgage contract.

Consumer heterogeneity – responsible lending, counselling rules and usury[10]

Issues and evidence

FGR 9 calls for a counselling duty, as did the 2002 CCD proposal in Articles 6 and 9. The argument is that disclosure standards alone will not sufficiently protect some consumers, making them vulnerable to abusive practices.

Data from the US, where consumer heterogeneity in mortgage finance is more pronounced and better researched than in Europe, demonstrates in fact

[10] Usury is discussed in this section of the paper, although it traditionally is an element of material consumer protection. Our point is that responsible lending concepts and usury rules try to address essentially the same issue – capping burden arising from pricing excesses due to consumer heterogeneity.

clearly that culture, literacy and access to information matter to the quality of financial decision-making of consumers and that these factors are regionally concentrated.[11] According to US government analysis[12] financial illiteracy of consumers in particular is at the core of vulnerability to abusive lending practices. To the extent that lenders systematically exploit the situation to their advantage, market failure may be the result. So-called 'predatory' lending practices, for instance, target vulnerable groups and lead to predictably high default rates and personal hardship. High default rates, in turn, may lead to market breakdown due to spiralling credit supply costs, or to a regulatory backlash.[13]

FGR 17 may be seen as the contrasting call for lenders to remove legally enforceable interest rate caps that pre-empt lenders from doing business with such groups with a higher default probability, paralleling the US federal deregulation taken in the early 1980s. Most recently, the issue has been assessed by the UK Department of Trade and Industry for the case of personal loans, which has sparked strong consumer group reaction.[14]

Regulation options

The main approaches at hand to address consumer heterogeneity in mortgage finance are

- to force lenders to disregard elements of the identity of the consumer upon underwriting (anti-discrimination rules),
- to penalise detrimental advice given to consumers, or alternatively to call on lenders to advise consumers duly and underwrite them responsibly – as proposed,
- to limit interest rates (and by implication ration credit away from risky groups),
- to enhance consumer education levels.

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11 For example, Deng, Pavlov and Yang (2003) find that borrowers from affluent Western Los Angeles both refinance and move quicker than predicted by standard estimation techniques, while those in less affluent areas tend to stay longer than expected with their properties and loans.

12 US HUD & Treasury (2000).

13 This happened in the US: following deregulation in the 1980s default incidence in the subprime market in the 2001-2 was on average 15 times higher than in the prime market, with one in every 15 mortgages being in default (Saunders and Cohen, 2004). Hence, by 2004 over a dozen US states had re-regulated mortgage lending, raising concern in the mortgage industry about increasingly heterogeneous practices and detrimental consequences for the entire subprime market.

14 See H.M. Department of Trade and Industry (2004) and Reifner (2004), also Masciandaro (2001) for a pan-European review of usury regulations.

While the CCD is silent on anti-discrimination, other recent EU regulation[15] has addressed the issue following the earlier example of the US. This should cover the mortgage sector.

The 2002 CCD proposal contains a provision for responsible lending, which draws on earlier UK FSA formulations. To a degree the language of responsible lending mirrors formal financial regulation requirements that force lenders to assess the borrower's ability-to-pay.[16]

However, financial regulation requirements may not be formulated clear enough and in particular, if Basel II becomes implemented as intended, lead to the highest prices to be paid by the consumers most vulnerable to default.[17] The question is thus whether such price differentiation, which is today encouraged by financial regulation, will not be discouraged by consumer protection. This is an acute danger, especially when the onus is laid on the lender as in the case of responsible lending and when usury regulations remain in place. There is considerable risk, for example, that consumers willing to pay higher mortgage rates might be pushed into grey market financings where they face significantly higher credit costs.[18]

To call this issue is difficult, although not impossible if an appropriate credit risk model is developed that addresses the consumer's risk profile and hence probability of default correctly. Such models should be the basis for both financial and consumer protection regulation and could be reasonably considered to remove the onus on responsible underwriting and breach of usury rules from the lender. The conclusion is that Article 9 CCD should either be specific about the conditions that constitute such responsible lending/underwriting practice, as does financial regulation today, or be removed. Moreover, there is room to render usury ceilings more flexible by allowing empirical credit risk pricing and a graduated regulatory response. For details of a risk-based approach, see our proposal on product harmonisation below.

Calls to introduce a duty to advise consumers as reflected in FG 9 should be rejected. As the FG Report states, European Member States universally abstain from regulating the matter; for good reason. Lenders face a conflict of interest when being mandated to perform counselling. Their economic goal is to sell the most profitable product, which will be impossible to reconcile with the requirement to sell in parallel a public good, advice to consumers on

[15] Directive 2000/43/EC

[16] Crucially, probability of default assessments are also called for under the Basel II risk-based capital approach.

[17] There is clear evidence for instance that high loan-to-value ratio loans have become more expensive in relative terms in Europe since the beginning of the decade in Europe. Hypoport, the largest German broker, estimates that the margin for 90% loan-to-value loans have widened from 45 bp in 2001 to almost 60bp in 2004. See www.verbriefung.de.

[18] See also DTI (2004) on the effect of usury ceilings on credit supply for low-income households.

their financial circumstances. If implemented, the rule would impose strong litigation risks on lenders and would certainly reduce incentives for product innovation. Even intermediaries that work on behalf of several, often dozens of lenders are weak candidates for such rules because their fee structure often provide incentives to market products of particular lenders, or particular products. Disclosure of such relationships could be the appropriate response here.

What would make sense is a requirements for both lenders and intermediaries to provide consumers with comprehensive product information. Moreover, as argued further below, certain products place greater interest or default risk on the borrower and therefore warrant heightened disclosure standards. Additionally, it would be worthwhile to promote positive consumer debt databases that would give more accurate information to lenders about effective debt service burdens.

It is finally important to note that financial literacy is at the heart of the problem, an issue which can only be addressed by providing the public good financial education. The US Housing and Urban Development Department (HUD) for instance has developed a Housing Counselling Assistance Programme, under which brokers, housing agencies, charities and consumer groups are certified and partially funded as consumer counsellors. Pre-borrowing counselling is in fact mandatory for loans to low-income borrowers that are eligible for federal public loan insurance.

Assessment

Table 1 contains the high-level assessment of FGRs with relation to consumer information and counselling. It would appear that all relevant aspects of the CCD and slightly beyond are addressed by the FG as far as they are not already regulated elsewhere (for example in EU Directives on unfair terms, misleading and comparative advertising, anti-discrimination, distance selling).

Moreover, the agreement on disclosure standards is sufficiently broad to be able to move a step further. The ESIS at least is a success in terms of generating consensus, even if implementation may be lagging behind. Rendering such disclosure mandatory should impose limited implementation costs and be particularly useful for accession countries with as yet intransparent markets.

The APRC discussion, which is inextricably related to disclosure standards, in contrast, continues to be misguided by the lack of understanding among the FG of the character of different mortgage products and their huge impact on APRC figures. To put it simply – callable and non-callable fixed-rate mortgages are as comparable or incomparable with each other as a BMW with a Volkswagen. Prices differ by quality, and quality needs to be held constant within some range to render price comparisons meaningful for the consumer. Discussions about cost factors to be included into or excluded from the APRC need to be subordinated to this perspective, and the CCD should, if transposed, amend the proposed APRC regulation with an appropriate classification of mortgage products. With regard to the ambit, both narrow and broad lending rate definitions made by the CCD proposal appear reasonable and applicable to the mortgage sector. Using both concepts should be acceptable for all parties in the FG.

Concerning the problem of consumer heterogeneity, the EU lags behind the US. An area where the EU could learn from the US is the provision of public goods to low-income borrowers in the form of financial education, counselling and certification systems. Responsible lending rules and mandatory counselling are questionable, given the conflicts of interest faced by lenders. In the case of responsible lending rules and remaining usury ceilings, there is a clear conflict between financial regulation, which calls for risk-based capital and in hindsight pricing, and the intention of consumer protection to pre-empt self-defeating consumer finance arrangements. Use of objective risk models could solve this conflict and ought to suffice as proof of a lender's good intentions.

In general, the benefit-cost relation of harmonisation for the mortgage sector appears highest in the areas of standardised APRCs and the use of the ESIS, and lowest in the areas addressing consumer heterogeneity.

Material consumer protection/product harmonisation

Forum Group approach

Product standardization and harmonisation approach - a case study of different integration policies with a four-country sample

It is useful to combine the discussion of the FGR in the material consumer protection area with an evaluation of the general legal approach surrounding the Rome Convention (FGR 20/21) and the harmonisation strategy pursued by the CCD.

- In FGR 9 consumer groups advocate what has been dubbed a "minimax" strategy, a minimum harmonisation approach that allows national regulators to impose 'stricter' consumer protection rules, with product standardisation on the 'highest' possible level.
- Lenders are split on the issue:
    - A majority of lenders is in favour of a "maximin" strategy, a full (maximum) harmonisation approach on the lowest possible common standardisation level.
    - A minority of lenders argues against any harmonisation and in the spirit of the Second Banking Directive in favour of a revision of the Rome Convention that would allow for free choice of applicable law (free choice of law, FGR 20).

The common denominator of the lender positions is clearly their opposition to the minimax approach, that is, the appeal to allow a maximum number of products while limiting regulatory intervention to a minimum.

The mortgage markets of the United Kingdom, Spain, Germany and France serve as our analytical example to review the impact of these fundamentally different regulation approaches. These four markets are chosen because they feature four distinct core products, defined as those products with the largest market share. As the EMF-MOW study has shown, they also represent different price and cost levels with regard to refinancing, administration and risk costs.

The analytical interest here is limited to two key regulatory dimensions of relevance for the material consumer protection debate:

- unilateral adjustment of contract conditions, especially with respect to adjustable-rate mortgages, and
- whether and to which extent prepayment indemnities can be charged and by implication so-called callable and non-callable fixed rate mortgages coexist.

The discussion is broadened later to credit risk aspects, such loan-to-value ratios and indebtedness. In the meantime it is observed that

- the main product in the UK is the Standard Reviewable Rate mortgage (SVR), a contract whose lending rate can be adjusted unilaterally by the lender according to his funding conditions. Short-term deposits are the main funding instrument in the UK.
- the main Spanish product is an index-tracking adjustable rate mortgage; the most heavily used index is Euribor, whose variation matches broadly the variations in costs of funds of Spanish banks. Pricing is still mostly over deposits, although the share of MBS and Cedulas, a version of covered bonds, is increasing.
- the principal German product is the non-callable fixed rate mortgage priced over the *Pfandbrief*, a covered bank bond. Non-callability refers to protection against prepayments either through contractual exclusion or (increasingly) yield maintenance prepayment indemnities.
- the main French product is a callable fixed-rate mortgage with only nominal prepayment indemnities.[19] Pricing in France has been traditionally strongly followed deposit rates, but increasingly uses capital markets instruments including the French version of MBS and covered bonds.

[19] The Scrivener Law of 1979 cuts these at 3% of the residual loan amount or 6 months interest payments.

The status quo – (no) mutual recognition

The intention of the Second Banking Directive is to help the internal market of the EU Treaty for the banking sector to become reality. The main concept is mutual recognition of lenders and products based on free choice of applicable contract law, in essence home country control. However, the minimum harmonisation approach of this and other Directives, especially in the consumer protection area, led to the prevalence of strong national regulatory barriers to entry in the name of the general good. Proponents of those barriers see themselves emboldened by the Rome Convention, which is interpreted as to grant consumers the right to rely on their national law when closing contracts, in effect reinstating host country control.

It is safe to argue that this set of contradicting policies could not, and under likely circumstances in the future will not, lead to an integrated European mortgage market. The argument is implicitly lender economics; the existence of regulatory barriers impair the tradeability even of domestic core products across borders – core products are those in which home country lenders have a natural cost advantage, which they could exploit for costly cross-border entry strategies.

The analysis proceeds by observing that the two variable-rate and the two fixed rate products that form the core in the four sample countries represent antagonistic pairs from the viewpoint of consumer protection:

- the SVR and the index-tracker mortgages coexist in the UK, whereas the SVR contract is banned in Spain (as well as France). Spain instead offers lenders the option to use costs of funds indices computed by lender groups. These are, however, rarely used in practice. In essence, the UK approach gives priority to market completeness, while the Spanish approach reflects a desire for greater standardisation and consumer protection via mandatory use of objective indices.
- the German non-callable and the French callable fixed-rate mortgage form a second antagonistic pair, although yield maintenance indemnities are limited in Germany to 10 years and a low level of prepayment fees can be charged in France. However, clearly, the German civil code and the French Scrivener Law take different approaches: while in Germany both call protected (up to 10 years) and callable fixed-rate loans are allowed, in France, essentially due to Scrivener Law only callable contracts can be offered.[20]

The result of this structure is that the insular European mortgage market formed by the four national mortgage markets in our example must be highly incomplete, whatever the actual economic incentives, because mutual recognition is in practice superseded by national consumer protection rules.

[20] It is perhaps worth to note that, in practice, in Germany callable loans are not offered, so while Germany is pursuing a de jure complete market policy in this dimension, the market is de facto incomplete. But this does not alter the argument.

- Only the UK currently admits all four core products, SVR, index-tracker, callable and non-callable[21] fixed-rate mortgages.
- Germany admits three of the four contracts - the Spanish core product of index tracking adjustable rate contracts falls formally under the price clause ordinance and faces potential regulatory hurdles.
- France and Spain admit only two of the current four core products, callable fixed-rate mortgages and index-tracking adjustable rate mortgages. In Spain, prepayment indemnities for non-callable fixed-rate mortgages as practiced in Germany, are not legally prohibited, but limited by industry practice, which has infiltrated case law.
- Only the French core product can be sold universally within the 4-country group.

Within the group of four, hence, only two pairs of full mutual recognition of core products can be identified: the United Kingdom and Germany on the one hand, and Spain and France on the other hand. Thus, under the status quo, the single internal market is fragmented into two: a Northern, and a Southern bilateral internal market, shown in Figure 1.

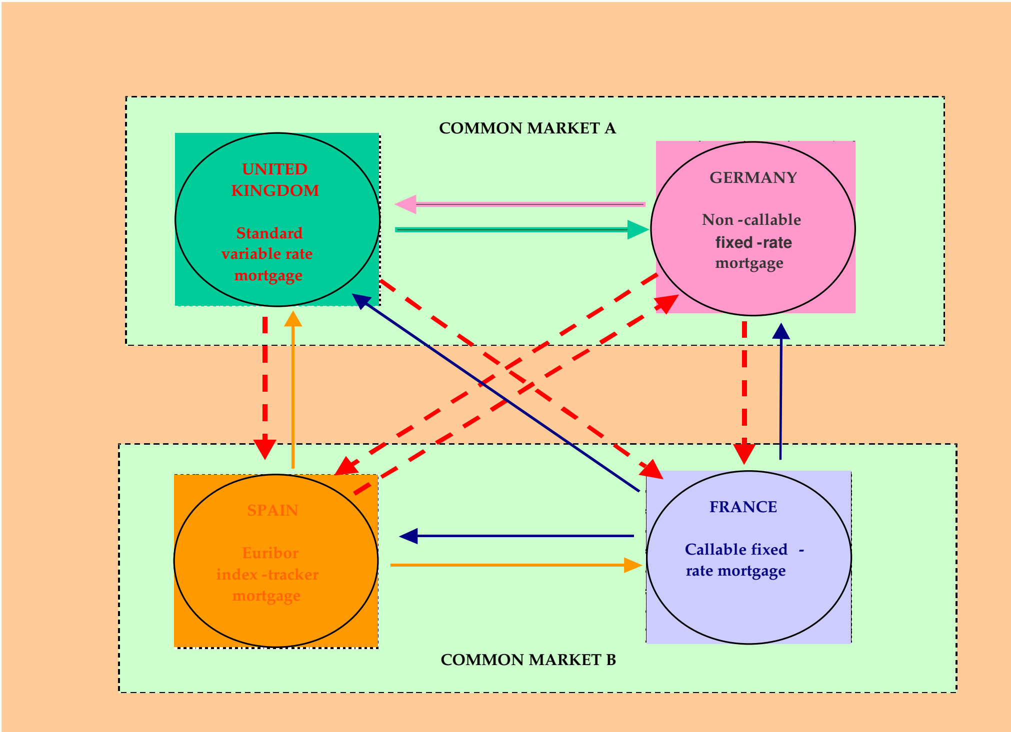
The argument applies *mutatis mutandis* to discussions involving additional Member States, product classes and features, and delivers a patchwork of bilateral or multilateral internal markets.

Since mutual recognition represents the status quo, any attempt to create a complete European market on that basis would necessarily require in fact a change of the Rome Convention in order to truly enforce home country control of lenders and products (FGR 20). However, it is doubtful that even if this controversial step would be taken, it would suffice to reach the desired mutual recognition effect.

Both in the US mortgage and insurance industries, for instance, federal regulations providing for home country or federal control are superseded by state regulations limiting contractual freedom. Insurance institutions, for example, tend to concentrate in the states with lowest levels of regulation and taxation. However, the host states have all intervened into cross-border offerings coming from the home states and ultimately imposed their own, usually stricter standards.

[21] In the past few years, court and ombudsman interventions in the UK in order to limit prepayment indemnities took place; however, these refer to indemnities for low initial fixed rates offered as teasers for SVR or index-tracker products.

Figure 1: Four-Country-Sample – (No) Mutual Recognition, the Status Quo



Notes: green areas denote common market. Solid arrows denote legally admitted cross-border supply, broken arrows denote legally prohibited or prohibitively costly cross-border supply.

An argument made by some proponents of mutual recognition is that it is mainly lender economics, not regulatory barriers, that pre-empt cross-border lending. As the MOW study shows, this argument has in fact plenty of economic support. Prices fetched by mortgage lenders, adjusted for options costs, are generally low in Europe, although there is some variation. However, the study also points out that incompleteness of national mortgage markets in Europe is still very high and its removal holds a large empirical potential for higher consumer utility and growth. It is hard to see – this is apparently accepted by a majority of FG participants - how the potential can be realised without removing at least the formal legal and regulatory obstacles to cross-border lending, at least of core products.

What are the chances of removing the host country consumer protection mandate enshrined in the Rome Convention to make mutual recognition work? Under the mutual recognition logic, this can be reduced to the question whether the least protective national mortgage market offers still acceptable sufficient protection levels to the consumer from the perspective of all remaining member states. In our example, this could mean convincing Germany, France and Spain to accept UK consumer protection standards – not a realistic perspective considering EU voting rules. Harmonisation on a level acceptable under EU voting rules seems to be the only serious way forward to remove the regulatory barriers.

The minimax approach – consumer's dream and lender's nightmare?

The idea is minimum harmonisation allowing for 'higher' consumer protection standards imposed by national regulators without a specific permission entered into the Directive. Minimum harmonisation has been the approach of the 1987 CCD, but is no longer part of the 2002/4 reform proposals.[22]

In order to maximize the perceived consumer protection impact further, harmonisation should standardise contracts to the degree possible, addressing the standard canon of material consumer protection issues. It is not speculative to infer from previous studies[23] and public demands of consumer groups both in our four-country sample and represented in the Forum Group about the nature of such a Directive. It would in the chosen core product example aim to:

- Outlaw or severely restrict the current German yield maintenance indemnity practice that leads to non-callable fixed-rate mortgages.
- Outlaw individual lender adjustments of base rates for adjustable rate mortgages and replace them by 'objective' indices, following the Spanish or French approach.

The result is depicted in Figure 2. The green zone, the internal market, would effectively be limited to the current Franco-Spanish common market, reflecting those standards of consumer protection. Moreover, individual countries would be enabled to enter into a 'race to the top' by imposing higher standards individually.

A possible benefit of such a policy in our example would be to effectively reduce the number of options that can be included into a contract, especially options that lenders could exercise, which in turn would protect very vulnerable consumers from negative financial outcomes. For instance, a consumer under a German non-callable fixed-rate product with little understanding of interest rate cycles might decide to lock the interest rate at a very high rate level, which might in combination with a high loan-to-value ratio create financial risk.

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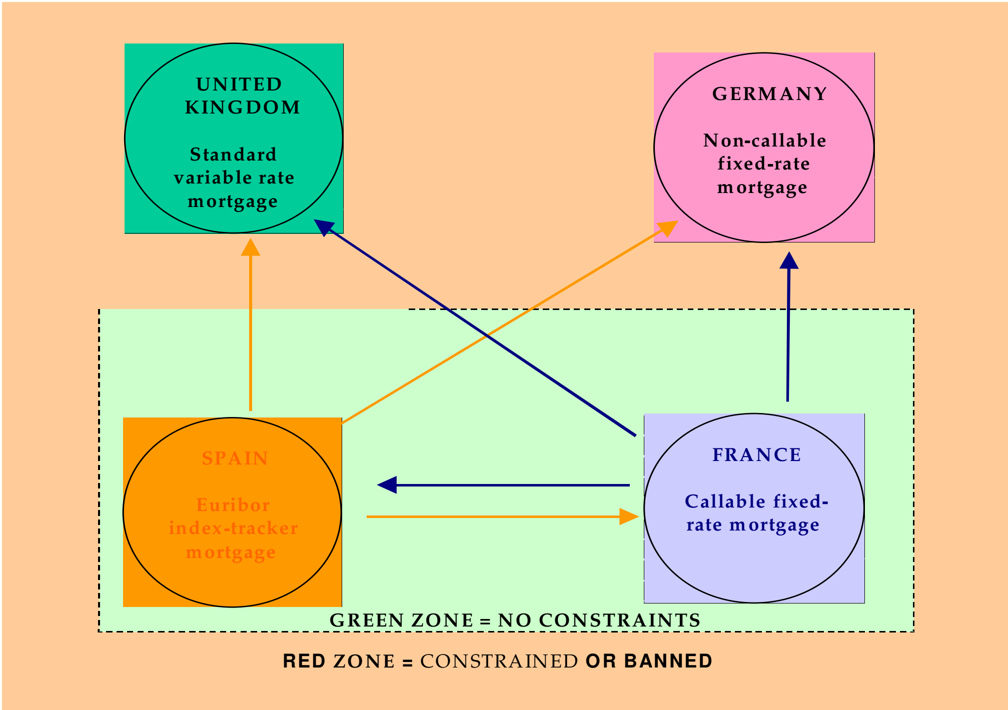
[22] The Commission, in fact, in 2004 rejected a proposal by the Parliament to reinstate the minimum harmonization principle for the CCD.

[23] See for example Tiffe/IFF (2004).

Figure 2: Four-Country-Sample – the Minimax Approach



Notes: green areas denote common market. Solid arrows denote legally admitted cross-border supply, broken arrows denote legally prohibited or prohibitively costly cross-border supply.

On the other hand, compared to the status quo, the costs of the minimax policy would be the disappearance of two of the four products. This would not only impose large adjustment costs on lenders in the current 'Northern' common market, which the countries affected would likely vote down.

It would also, because of the maximum standardisation level sought, reduce consumer choice of products that are potentially less costly everywhere in Europe. It is intuitively clear that products with greater lender options such as SVR adjustable-rate or fixed rate mortgage loans with the option to charge prepayment indemnities provide greater degrees of freedom for asset-liability-management for lenders and thus carry the potential to be offered at lower costs (see the discussion in the subsequent section). The EMF-MOW study for instance has impressively demonstrated that the German non-callable fixed-rate mortgage carries the lowest adjusted price in Europe. Clearly thus, the protection of certain vulnerable groups selecting those products should be gauged against the costs of removing core products from the European menu imposed on the entire borrower population.

The crucial question therefore is: is the vulnerability of consumers to inadequate product choice large enough as to favour such a bold standardisation move? This could be stipulated, for example, if self-selection and product/price differentiation could be shown to produce individual hardship and/or excessive financial burden to consumers. The paper comes back to this point later in the discussion of prepayment and unilateral rate adjustment below.

The maximin approach – a liberalised European mortgage market

The diametrically opposed policy concept to minimax is the maximin approach of maximum harmonisation at the minimum possible level of product standardisation. Maximum harmonisation will disallow 'higher' national consumer protection levels, except in areas identified in the Directive.

The maximin approach intends to cure the deficiencies of the mutual recognition approach identified above and get the Second Banking Directive to work. The chosen route is elimination of constraints imposed on cross-border lending due to the political infeasibility of home country control by creating a broad common level playing field. Figure 3 demonstrates the concept with our four-country sample. The green zone of product recognition by host countries would be expanded to the entire market.

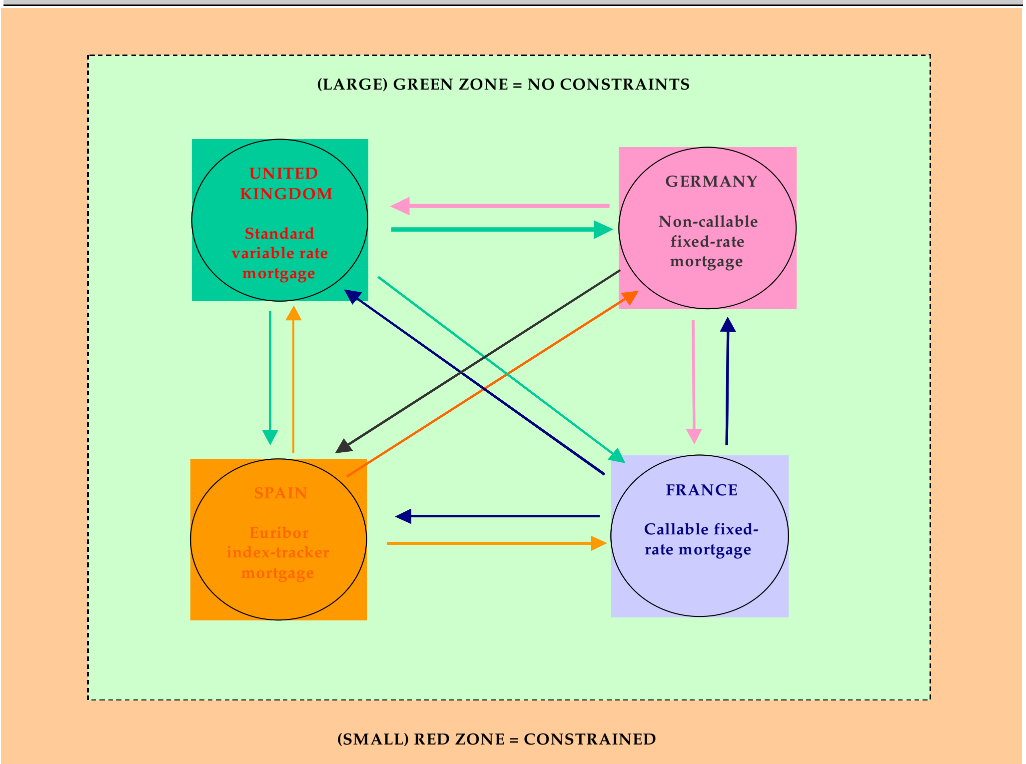
Note that this requires, even in the simple example with only four products, several bold legal and regulatory steps:

- Germany would have to remove remaining hurdles for index-tracker mortgages, eliminate the lender option for contractual exclusion of prepayment and possibly reform prepayment indemnities.
- France would have to reform the restrictions on prepayment indemnities formulated in Scrivener Law and allow call-protected mortgages. To a lesser degree, given the less formal constraints, the same argument applies to Spain.
- Spain and France would have to accept reviewable rate mortgages, which are currently banned.
- Only Britain, in the given narrow product example, would not have to change the legal context. However, she would be affected by other elements of maximum harmonisation.[24]

It is likely that despite these necessary adjustments the direct implementation costs within the banking industry will be rather modest, since the main emphasis is to broaden the product menu. In addition implementation costs are almost randomly distributed, compared to the minimax approach, which would put the 'North' under a unilateral adjustment burden.

[24] For instance, the effect of the 2002 CCD proposal on the current consumer protection regime set up by the British FSA would be substantial, including the widening of definition of credit intermediaries, new provisions on linked transactions and mortgage guarantors, new database requirements, changes of scope of the APR, new information requirements etc.

Figure 3: Four-Country-Sample – the Maximin Approach



Notes: green areas denote common market. Solid arrows denote legally admitted cross-border supply, broken arrows denote legally prohibited or prohibitively costly cross-border supply.

Second round effects may well be conceivable, though. For instance, entry of the German low-cost non-callable mortgage product in the French or Spanish market may force local lenders to adjust their product menu. On the other hand, *Pfandbrief*-style refinancing products that would allow low-cost offerings of non-callables are available in those countries, and in fact were strongly used in France in the past (Marche Hypothecaire of the 1980s). The situation is similar with the British SVR product entering Spain or France; in fact, it is more likely that a greater availability of index-trackers in Germany and thus broader European liquidity will step up market pressure in Britain that cuts into the market share of SVRs, something which fixed-rate mortgages apparently were unable to do in the past.

Maximin also avoids a key risk for consumer protection arising from the mutual recognition approach. While governments cannot impose higher standards, there is in fact a minimum level of protection in place, and it would not be the least protective market that would sets the standard.

Still, the question arises how 'low' or 'high' that consumer protection level should be and whether the maximin approach does not sacrifice either the idea of a common European consumer protection policy or of a liberal common market.

Selected issues

Unilateral rate adjustment

Issues and evidence

It is interesting to note that the FG has not dealt with unilateral rate adjustment while the 2002 CCD proposal had proposed strict regulation, and this in an area which is among the most contested in the consumer protection debate. In fact, as Table 2 demonstrates, European regulatory regimes differ significantly and, as shown before, this establishes a significant barrier to cross-border lending. Product development and differentiation in the area is strong, and the advent of credit risk pricing in the wake of implementation of Basel II may increase the requirements for flexibility in the area. The consumer protection debate centres on four basic questions:

- Which type of cost-of-funds adjustment mechanisms should lenders be allowed to use?
- Should spreads charged over those cost-of-funds be required to be constant or variable?
- In cases where interest rates paid by front and back book clients differ, exploiting transaction costs of prepayment for the back book clients, should that practice be limited or pre-empted?
- Finally, should caps be imposed on adjustable interest rates?

The debate is still very active in Europe and likely to gain in momentum, given the strong rise in popularity of adjustable-rate contracts. Given their risk profile, local consumer groups, for example in the UK or Italy, are lobbying for interest rate caps. Both risk exposure and back book discrimination was a focus of a recent UK Treasury Review ('Miles Review') with the goal to improve practices and reduce the dependency on adjustable-rate products. Miles found for example that SVR rates lag a downward trend in rates and that existing business borrowers pay on average 141 bp over new businesses.[25]

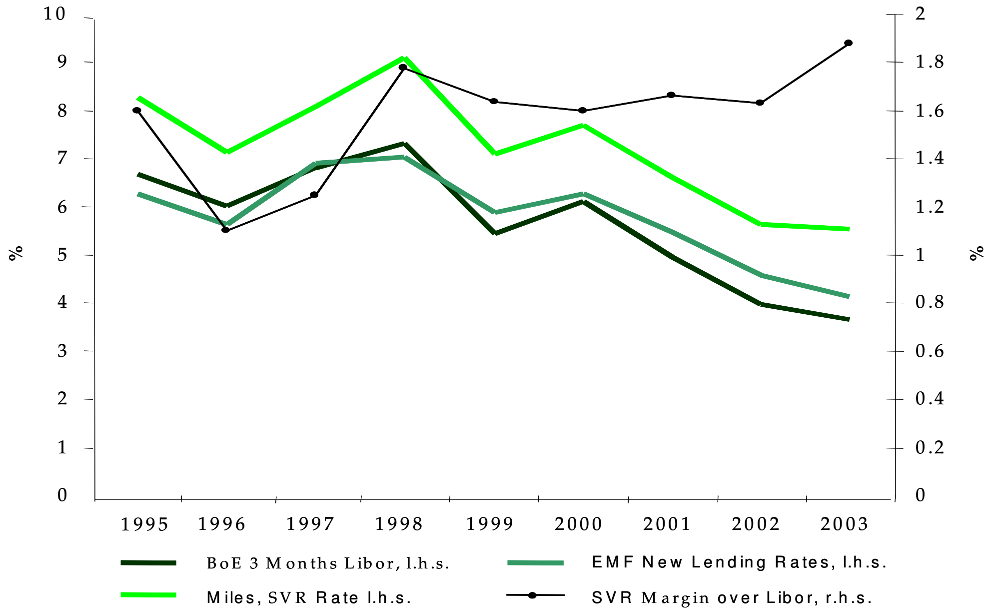
Figure 1 displays data for the UK that report the Miles findings for SVR spreads over Libor and compares those to EMF data on new contract rates. The adjustment lags over interbank debt are not particularly large, yet still visible.[26]

Discrimination between front book and back book is practiced relatively widely in Europe and occurs also in fixed-rate lending. German lenders tend to differentiate interest rates upon reset negotiations - '*Konditionenanpassung*' – which may lead to rate spreads between new and existing customers of approx. 50bp.

[25] See HM Treasury (2004a).

[26] See also Dübel, Lea and Welter (1997) presenting comparable data on German savings banks compiled by IFF Hamburg.

Figure 1: Average and New Mortgage Rates and Libor, UK



Sources: Bank of England, Miles Review, European Mortgage Federation.

Notes: EMF new lending rate: representative interest rate on new mortgage loans. SVR: Standard Variable Rate.

The Miles review made the argument that preferential rates for front book clients are not just unfair to the back book borrower population, but also inhibit product diversification. An example would be fixed-rate mortgages in the UK that appear expensive relative to the practice of adjustable-rate contracts with underpriced initial fixed-rate periods of 1-2 years. This assumes that consumers are not aware of the long-term cost of credit of either product, in particular in the presence of distortive use of APRCs for product classes of distinctly different nature.

Regulation options

Adjustment lags and back book price discrimination can be eliminated or minimised by supporting the development of certain products, including mortgages with fixed or capped interest rates until maturity, index-linked adjustable rate mortgages and roll-over fixed-rate mortgages priced at constant spreads over a capital market benchmark.

In Germany, reviewable-rate products all but disappeared in the 1990s, giving way to short-term fixed-rate mortgages priced over *Pfandbriefe*, and with the advent of index-trackers are unlikely to be revived again.

For the UK, where reviewable rates have still a significant market share, the Miles review recommends regulation that requires lenders to offer their entire product menu all borrowers, including old ones, and increases transparency about the process of prepayment. The goal is to put pressure on the price differentiation by higher prepayment and/or product switching activity.

The French and Spanish approach, as discussed before, is to render the use of official indices mandatory. In that regard the Spanish Transparency and Consumer Protection Act is particularly instructive. Under this law, the Bank of Spain publishes 5 reference indices on a monthly basis: 1 year Euribor, 1 year interbank rate (MIBOR), secondary market yield of public debt between 2 and 6 years maturity, reference mortgage interest rate > 3 years, and reference lending rates of savings banks. The indices offered are sufficiently long-term to reduce base rate volatility for the contract, and – given their width of coverage – are widely accepted in the industry. The dominant index is the 1-year Euribor. The 2002 CCD proposal essentially follows the Spanish approach in Article 14 (3) by imposing the use of an agreed 'index or reference rate' as well as otherwise fixed conditions.

Table 2: Adjustment Regimes for ARMs, Lender Options and Constraints

	Compulsory Base Rate Indexation	Spread/Fee or Rate Adjustment Option by Lender	Indexed vs. Reviewable in Practice	Interest rate or payment caps widely practiced?
Denmark		●	Not applicable*	Yes
France	●		Indexed	Yes
Germany		●	Indexed**	Yes
Italy	●		Indexed	No
Netherlands		●	Reviewable	No
Portugal	●		Indexed	Yes
Spain	●		Indexed	Yes
UK		●	Reviewable	No

Sources: EMF-MOW (2003), Dübel (2003), Merrill Lynch (2003).
Notes: ARM: Adjustable-rate Mortgages. *Prices for Danish floating rate bonds are determined by public auction. ***Preisklauselverordnung* of 1998 requires lenders to seek the approval of the Federal Office of Economic Affairs (*Bundesamt für Wirtschaft*), de facto impact as product innovation or cross-border barrier unclear

It is important to note that measures taken to contain back book discrimination do not render mortgages less expensive considering their all-in-costs, or lead to an inability of lenders to roll over cost increases or desired higher profit rates to borrowers. This is ultimately a matter of competition. Also, such measures are questionable if implemented alone on the grounds of high transactions costs of prepayment, which can almost be eliminated as the US or Danish examples suggest.

What containment measures imply moreover is that loan pricing is moved fully to the front-end of the loan – the time of contract closure. The implication is that aggregate changes in lender cost are charged entirely to the newest loan cohort. Unsurprisingly, Figure 1 suggests for the UK that indexed-linked mortgages display stronger price volatility for new loan cohorts than SVRs, which enable lenders to roll over cost changes on the entire borrower population.

A third, so far largely ignored aspect is whether changes in the credit risk situation of the borrower should lead to unilateral adjustments.

- In the Danish mortgage market, for example, traditionally mortgage credit institutions have been able to charge aggregate credit cost increases over the entire borrower population.
- Such an approach is hardly possible anywhere else in Europe, and leads to flagrant conflict with the risk-based capital and consequently risk-based pricing approach pursued under Basel II. Here the reviewable rate structure allows for some degree of freedom to pass on an increase credit costs to the borrower collective, as do some of the adjustment options offered by the Spanish Transparency Law.[27]
- The alternative would be to allow lenders to adjust their risk premium, that is, the real rate, even as index-trackers or other objective rate adjustment criteria are being used.

The team believes that by and large the trend towards use of official indices is already strong in Europe, and regulations aimed at containing possible abuse should rather follow the differentiated approach proposed for the UK than formal regulation. If regulation is passed, it should offer lenders and consumers a broad menu of base rate options, as in the Spanish case.

Should interest rates on ARMs be statutorily capped? ARMs used to be banned in some jurisdictions for fear of inflation risk.[28] However, at least in the EMU interest rate environment, this is no longer justified. Moreover, currently capped ARMs are strongly on the rise in continental Europe, notably in France, Denmark and Germany. This is not yet the case, however, in traditional ARM markets, like the UK and Spain, where the house price/interest rate situation may warrant it most.

It seems that a graduated response that discloses the risk associated with uncapped adjustable-rate loans would be appropriate. This can be done by providing mandatory examples of interest rate burden with past interest rate risk data. The approach proposed by the Miles Review for the UK presents such an example of heightened transparency: the FSA requires that, in addition to the current warning, a clear indication of past variability in rates

[27] For example the option of lender groups to use proprietary cost-of-funds indices, which may be interpreted as non-risk-adjusted

[28] For example in Belgium, as well as in currently high inflation accession candidate Turkey.

and the impact of such variability on mortgage monthly repayment, is shown in the pre-sale disclosure form.

Prepayment of fixed-rate mortgages

Issues and evidence

While there seems to be relatively broad agreement about the need to harmonise early repayment fees, FGR 10 and 18 provide conflicting detail recommendations.

The prepayment option is a borrower option in mortgage finance whose value depends on interest rate volatility, the duration of the fixed-rate term and the behaviour of prepaying borrowers. It causes option costs that are added to the lending rate as a mark-up. Those costs can be considerable and in general are higher than credit risk costs or administration costs. Fixed-rate lending with prepayment protection in the form of indemnities, in contrast, saves these costs by charging a user fee for exercise of the option.

Almost all mortgage markets in the world and all European markets empirically apply prepayment protection to fixed-rate mortgages. The key reason is a preference of European capital markets investors, the main historic financiers of fixed-rate mortgages, to hold debt with characteristics similar to government bonds.

Only in US and in Denmark were there special historical conditions that led to reduced prepayment options costs for consumers: in the first case the role of government-sponsored agencies in issuing, and in the second case the role of institutional investors in buying callable debt. In both countries, the situation has changed over the past decade, which was characterised by huge prepayment waves, and callable fixed-rate mortgages are gradually retreating.

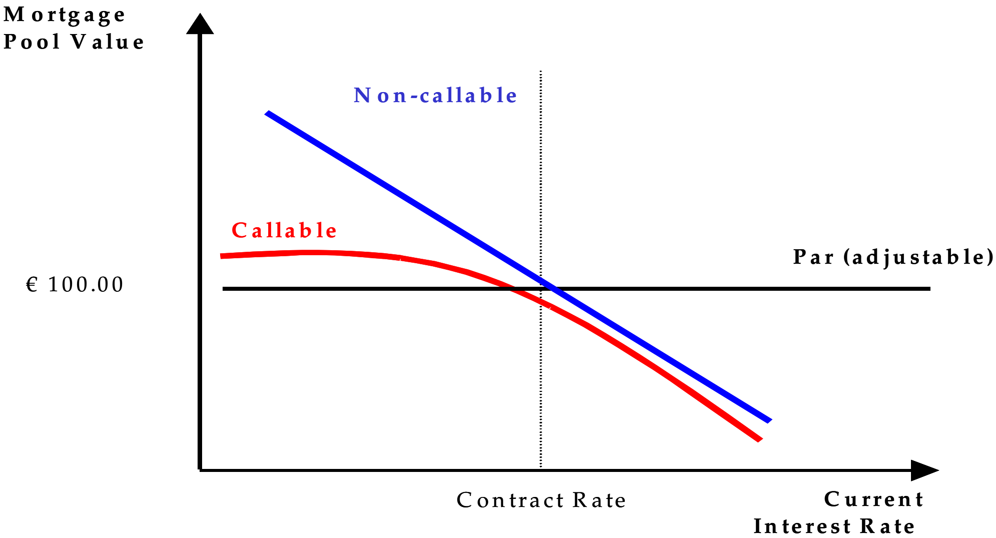
For the regulator, three fundamental issues arise on the subject, which are reflected in the Forum Group discussions:

- Should the prepayment option be universal?
- Should lenders be entitled to charge such indemnities as discussed above?
- What limits, if any, should be placed on indemnities?

The background for the first question is the occurrence of law that allows for the contractual exclusion of prepayment or is silent on the issue. This leads to serious reductions in consumer utility when, for instance, borrowers wishing to sell a house might have to seek the lenders agreement to do so. In contrast, the traditional argument of lender difficulties of managing the cash amounts received seems obsolete under today's financial market conditions.[29]

[29] The exclusion has been justified in Germany on the ground that extensive refinancing even with prepayment indemnities might lead to the replacement of too many mortgages in a collateral pool behind covered bonds through cash.

Figure 2: Mechanics of Callable and Non-callable Fixed-rate Loans



Source: Dübel (2004).
Notes: assume today's interest rates equal the contract rate, say 7%. Then the value of both callable and non-callable fixed-rate mortgage pools is approximately par (€100). If interest rates rise, both pools will fall jointly in value. The reason is that in the callable pool, only very few calls will be made, and none for them for financial reasons. In contrast, if interest rates fall the non-callable mortgage pool will rise much stronger in value than the callable mortgage pool. The reason is that financially motivated prepayments start to convert parts of the callable mortgage pool into cash which needs to be reinvested at par, e.g. into government securities or new mortgages carrying lower interest rates.

The second question is tantamount to demanding uniform pricing for a universal prepayment option. The tacit assumption is that if indemnities cannot be charged this means pricing of the prepayment risk as a mark-up over the loan for all borrowers, regardless of their propensity to prepay or assume a particular interest rate risk profile. Figure 2 displays the basic intuition of the valuation of pools of callable and non-callable fixed-rate mortgage loans, for example those protected by indemnities, in order to demonstrate this pricing implication.

Clearly, the fact that callable loans can be prepaid at par value (100) lowers the value of such a fixed-rate pool as interest rates drop. The callable fixed-rate loan pool becomes a hybrid – close in pricing behaviour to a non-callable fixed-rate loan pool if interest rates rise, and close to an adjustable-rate loan pool if rates drop. For the price differences that arise for the investor, an additional interest premium will be charged on the coupon, or alternatively the callable loan pool will be sold at a discount.

Obviously, one might forward operational or general good reasons that would speak in favour of pooling all borrowers into one uniform price:

- Impossibility to identify accurately separate prices.
- Consumer discrimination.

- Social costs incurred by separate pricing, such as overindebtedness or default.

The first issue is easy to defeat as the reinvestment gains or losses for lenders can be easily computed, more easily than the uniform price reflected in the prepayment option. With regard to the second issue, prepayment differs for example from credit risk pricing by referring to a simple consumer decision, not his characteristics. Clearly, financially naive consumers might have been talked into long-term fixed rates at the peak of an interest rate cycle, but the same risk would exist also in case of consumers contracting for adjustable-rates before a widely anticipated interest rate rise.

The background for the third question is the allegation of abuse of indemnities in order to overcharge consumers or lock them into high interest rates. In fact, the calculation of indemnities in Europe is far from uniform and in some countries limited by law[30], in others by industry agreement or standard[31].

Moreover, indemnities do not foresee compensation for prepaying borrowers if interest rates have moved in the reinvesting banks' favour. Only Denmark, applies a symmetric format by offering consumers the option to repurchase their fixed-rate loans at the going market price, which can be below, equal to, or above par. With Miles (2004) one might call this a 'marking-to-market pricing', or simply market price model of prepayment.

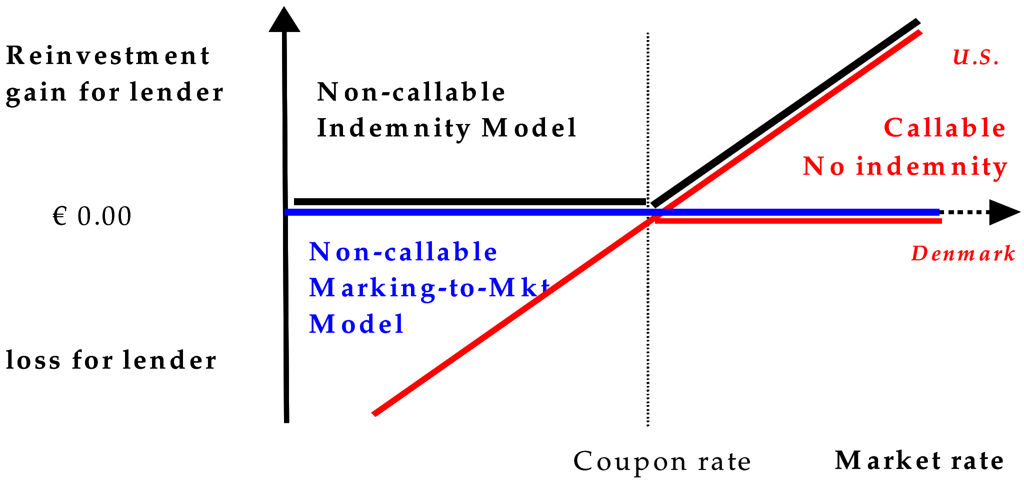
The blue line in Figure 3 represents a non-callable, or call protected, loan that will strongly rise in value as rates fall. If prepaying borrowers pay an indemnity to the lender in this situation, he will receive the prepaid amount worth 100 (cent to the Euro, black horizontal line) plus the difference between 100 and the blue line.

If rates rise under the indemnity model the prepaying borrower will pay no such indemnity. However, the lender will receive 100 while the value of the loan has fallen below 100, thus making a capital gain. Under the market price model, in contrast, the borrower may buy back the loan for below 100.

[30] France and Belgium.

[31] Italy and Spain.

Figure 3: Reinvestment Gain and Losses of Lenders from Prepayment



Source: author's representation.

Note: callable loans in Denmark are delivered and repaid at the market price. This is not the case in the US, where callable loans are prepaid at par.

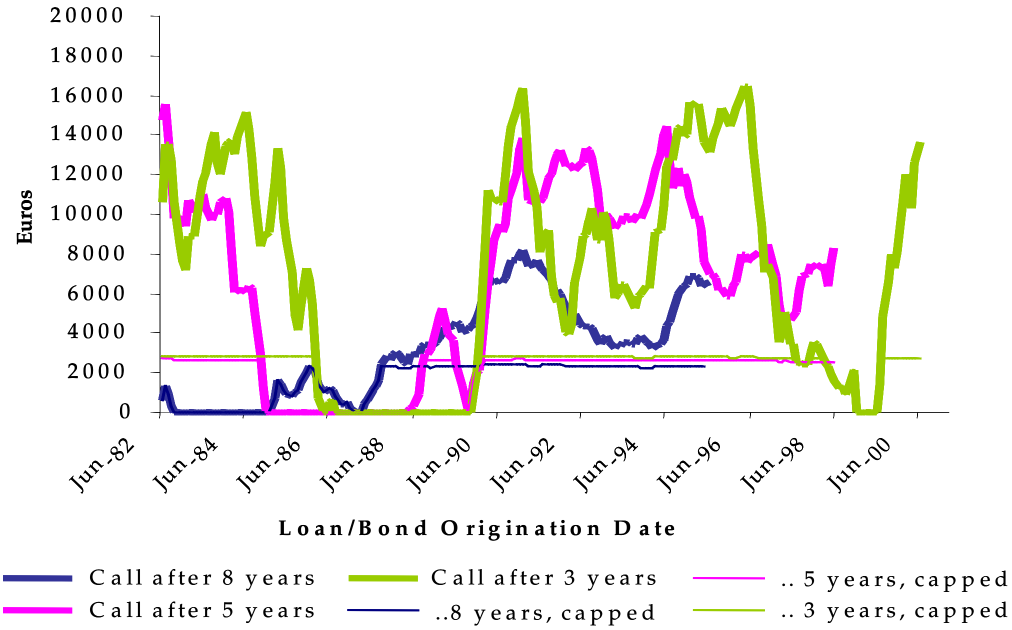
Concerning the form of indemnities, the main practical questions raised by stakeholders of the Forum Group in recommendations 10 and 18 are as follows:

How large can prepayment indemnities become empirically? Do large indemnities have an affordability impact on the borrower? Is there a need to cap the payments in absolute terms for affordability reasons? Is there a need to cap the residual fixed-rate (interest rate binding) period over which indemnities can be charged? Beyond yield maintenance, should the lender be entitled to charge for additional damages, in particular for lost servicing income?

Figure 4 presents simulation results undertaken by Dübel (2005) that look into the size of indemnities under the yield maintenance formulation based on comparison of mortgage rates. The simulation uses historical Bundesbank effective interest rates on newly originated mortgage loans in Germany, a series that was discontinued in 2003 when ECB took over the mortgage market statistics. It considers a € 100,000 loan with 10-year fixed rates, which the borrower wishes to prepay 8 years, 5 years or 3 years after the origination.

Figure 4 presents yield maintenance indemnity levels (bold lines), which fluctuated in historical perspective between zero and € 16,000. It should be added that even the German data were subject to a strong disinflation trend: rates in the period more than halved, from 10.1% in June 1982 to 4.8% in June 2003.

Figure 4: Historic Prepayment Indemnities due to Lenders



Sources: ***Simulation by Dübel (2005), monthly new mortgage contract interest rate data of Deutsche Bundesbank, 1982-2003.***

Note: Prepayment of a 10-year mortgage after 3, 5 and 8 years. Borrowers pays indemnity computed as discounted cash flow with the following elements: asset yield difference times outstanding amount times residual duration adjusted with mortgage interest rates as discount factors.

In the case of the limits imposed by Scrivener Law indemnities are capped at a level of 6 months interest of 3 per cent of the outstanding loan balance (thin lines). Note that the simulation operates for demonstrative purposes with German rates, which experienced a flatter decline than the actual French rates. Lenders facing capped indemnities thus clearly suffered reinvestment losses on many occasions in the past two decades. The shortfall in the Scrivener Law case is equivalent to a reduction of the loan value or equivalent bond price in Figure 2, from 120 to 105. As a result, French lenders had to charge a 'residual' prepayment option price as a second element of prepayment risk pricing - in the MOW-EMF study the estimate came to 29bp. Despite the price mark-up EMF sources speak of additional losses for French lenders in the range of € 10 billion over the period of 1986 - 2003.[32]

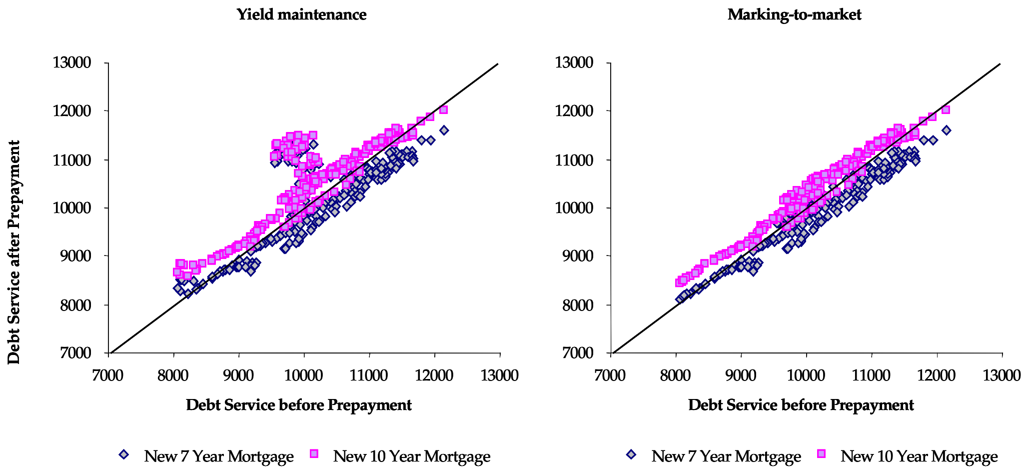
Figure 5 compares the debt service before and after prepayment, first for the yield maintenance indemnity model and subsequently for the marking-to-market model – again with historic Bundesbank data. It is assumed that the indemnity, or payout to the consumer if applicable, is capitalised into the new loan.

[32] Source: internal EMF evaluation of the FG results.

The most important result is that there is generally no affordability loss through payment of an indemnity and refinancing. However, in contrast to the fixed-rate mortgage with prepayment option, there is also no gain from prepayment.

The 'asymmetric' indemnity model creates an affordability issue, however, if interest rates rise, since the indemnity cannot become negative. This generates potentially 'lock-in', and discourage prepayment if, for example, the job situation requires relocation. Considering possible interest rates developments over the coming 20 years, such situations will likely occur more frequently than in the past 20 years, which were characterised by strong rate decline. This should speak in favour of implementing the marking-to-market model.

Figure 5: Historic Debt Service Payments before and after Prepayment



Sources: Simulation by Dübel (2005), monthly new mortgage contract interest rate data of Deutsche Bundesbank, 1982-2003.

Note: Prepayment of a 10-year mortgage after 3 years. Borrowers pays (indemnity) or pays and receives (marking-to-market) a discounted cash-flow computed as: asset yield difference times outstanding amount times residual duration adjusted with mortgage interest rates as discount factors. Indemnity or marking-to-market payout is capitalized into a new fixed-rate loan (7 year or 10 year), which is financed at the applicable rate at the time of prepayment.

It is interesting to note that approaches to deal with this problem do not necessarily lead to the desired economic result: in the Netherlands movers are exempt from paying indemnities, but the affordability problem arises precisely if and when such indemnities are already zero! Hence, the ruling presents a subsidy to movers when rates are falling, and no relief to the lock-in if rates are rising.

Whether indemnities should be limited at some level, and what that level should be, is empirically hard to assess. The maximum residual duration underlying a yield maintenance indemnity in Germany for instance is 10 years while consumer groups call for only nominal durations of 2-3 years. It can be demonstrated empirically with the simulation approach adopted above that the peak indemnities in the past 20 years were paid on durations of 6 or 7 years, as a result of the character of interest rate cycles. So longer is not necessary 'riskier'.

The credit risk argument ultimately boils down to underwriting criteria: loans that lock in a certain debt service are somewhat more vulnerable to negative equity situations (if house prices drop, and market prices of loans rise) than prepayable fixed rate mortgages. This would speak for somewhat higher equity requirement and sufficiently fast loan amortisation. However, non-callable fixed-rates with the typical durations of up to 10 years they are under most underwriting circumstances certainly less risky for borrowers than adjustable-rate mortgages, which have been booming in the past years in Europe.

It is important to understand that if prepayment indemnities or marking-to-market charges are legally impossible or capped, prepayment options costs are a necessary result. The most commonly used methodology for their determination is derived from market prices for bonds, which pass through prepayments to investors – in the US mortgage-backed securities, and in Denmark callable mortgage bonds. In the mid-1990s, pricing the very liquid MBS guaranteed by Ginnie Mae – a full faith and credit US federal government agency – off US treasury bonds of comparable duration yielded a typical range of prepayment option costs of between 70 and 100 bp.[33] However, during the past years, which were characterised by revolving situations of extremely high prepayments – such as during late 2001 and late 2002 – spreads have been reported to have widened beyond that level.[34] Similar observations can be made for Denmark, where options costs in the early 1990s were considered to be in the range of 30-45 bp, but since are considered to have increased.[35]

Whether a lender should be able to charge for foregone servicing profit, and how that profit is computed, is a more debatable issue. Empirically, in Germany foregone servicing profit charges may run between 1 and 3% of the prepaid loan volume, depending on the residual duration of servicing. Lenders apply low servicing costs as deductibles to arrive at profit estimates – this is an area that calls for standardisation. Also, administration fees vary considerably, between ~ €50 in Denmark and up to € 500 in Germany.

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[33] Dübel and Lea (2000).

[34] For example: Wall Street Journal of August 8, 2002: Bond Market Confronts Turmoil from Homeowners' Refinancings.

[35] Graven Larsen (1993) is one of the few references in the literature where explicit reference is made to the price of the option.

Regulation options

Harmonisation of the universal right of prepayment. Refusing a prepayment or charging arbitrary prices must be seen as an unfair reduction of consumer utility; such practices may in fact trigger defaults, and worse, limit mortgage demand due to the perception of financial inflexibility. FGR 10 should thus be supported.

Harmonisation of prepayment indemnities.

- The ideal solution would be to implement the symmetric Danish market price model, where borrowers of non-callable fixed-rate loans can repurchase them at the market price of the bond series in which they have been issued.
- However, the Danish structure is hard to implement in the vast majority of European markets that price loans over covered bonds or deposits and thus feature no direct matching of loan conditions and maturities with funding. In this case, the second best solution is to use symmetric yield maintenance computations, which are based on standardised benchmarks, such as comparable-coupon covered bond prices, discounting methods etc. Miles (2004) calls this a 'marking-to-market' model of prepayment charges.
- The asymmetric indemnity model is a third best solution because it may trigger increasing incidence of lock-in. Enforcing a negative indemnity would be tantamount to the marking-to-market model.

FGR 4 should thus be supported. Any CCD formulation allowing lenders to charge indemnities for damages should enshrine the principle of symmetry for cases in which lenders make reinvestment gains.

FGR 9, second bullet point, limiting the indemnity to the 'first few years' should be rejected since it would lead to only very short-term non-callable loans. A longer time period would be conceivable: 10 years produces the same or lower indemnity levels as 5, given the wave length of interest rate cycles, thus a maximum of 10 years should be acceptable.

FGR 9, third bullet point, calling for a statutory ceiling must be rejected based on the French experiences which have led to dual pricing of prepayment, through the indemnity and prepayment option price compensating for lender options.

Regarding the question of lost servicing income, a certain degree of agnosticism is appropriate: if a lender can no longer charge for lost servicing income, the result will be an increase in 'front-loading' of loan pricing, for example through higher initial rates or closing costs. This is the same point as concerning reviewable-rate mortgages. Cost deductions that lenders may apply, however, should be based on objective empirical review. Similarly, administration fees should be made more transparent and enforced to match actual costs, with the onus on lenders.

Deep scepticism is justified about different legal treatment of prepayment for different borrower groups, for example moving homeowners, or in cases of looming default. First, as the Dutch example shows, these are often not economically thought through. Secondly, they are extremely difficult to verify and just another source of costly litigation. Prepayment risk, after all, reflects interest rate risk and not credit risk.

Assessment

Product harmonisation is central for integration and development, but needs to be of high quality

The material consumer protection area is central to progress towards an integrated European mortgage market. Europe's legal idiosyncrasies in this sector in fact defeat the spirit, if not the words of the EU Treaty.

- The fact that mortgage credit products with large domestic markets cannot achieve any additional scale on the European level, something that is considered 20 years into the internal market as natural in the market for cars or air travel services, is pre-empting the restructuring of the mortgage industry by the creation of larger, more efficient production units. Europe is heavily overbanked and has a related excess supply of secondary market institutions. This fact in turn leads to self-fulfilling lack of economic contestability of domestic markets.
- Gaps in contestability are moreover the central driver behind the incompleteness of domestic mortgage markets, which was the central subject of the 2003 EMF-MOW study. Such incompleteness is depriving numerous borrower groups all over Europe from access to credit. Product differentiation that could relieve incompleteness remains a key foreign entry channel in finance, and should be legally enabled, whether it is used or not.

Does the US example, where state consumer protection standards in continue to prevail defeat the case for a more standardized European market? The answer is not affirmative, but the pronounced cycle of centralization and re-decentralization of consumer protection regulation through which the US went in the past 25 years[36] calls for caution with regard to the necessary quality of harmonization.

The lesson for Europe in our assessment is that the attempt to install common consumer protection standards need to be sufficiently analysed, discussed and agreed on. This requires thorough economic motivation and absence of ideological zeal. Moreover, some degree of subsidiary regulation ambit seems advisable as a valve for variation in local preferences or cultures. The Forum Group and other platforms exist or could be established as permanent discussion and learning platforms. What is missing is a serious economic

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36 See Saunders and Cohen (2004).

concept that could generate consensus, and an indication of which areas could be left to the subsidiary. This is the subject of the remainder of the section.

A risk-based approach to product harmonisation: a debate about consumer risk exposure devoid of empirical fact-finding

All Forum Group and CCD proposals so far have in common that the processes of both the analysis of solvency risk exposure of the consumer and regulatory response to a particular source of risk remain ill-defined. In fact, the sober reality is that the proposed responses in their majority reflect simply varying legal traditions in member states.

Several factors explain the lack of empirical analysis before arriving at legal conclusions about (typically foreign) products: legal and cultural traditions, institutional gaps both on national and European levels - especially a dearth of mortgage market research compared to the United States. It is no wonder then that, without a properly maintained and developed empirical basis, disagreements between different legal tradition camps are so long-lived.

The paradoxical disconnect between consumer protection and financial regulation

To demonstrate the shortcomings of the traditional law-making approach in Europe, compare the impact of various sources of market risk on consumer solvency and the regulatory response in the consumer protection, and by contrast the financial regulation law-making ambit.

- Interest rate risk in the Euro-zone has dropped significantly in the past two and a half decades since the so-called 'Volcker break' started the disinflation process with double-digit nominal interest rates. The ECB is widely held to have introduced a stable monetary policy regime for the Euro-zone, holding a credible promise of low interest rate volatility for the future.[37]
- Currency risk, in contrast, between the Euro and the US Dollar, the Japanese Yen or the Swiss Franc, has stayed at very high levels. In some economies, foreign-currency denominated mortgage loans are strongly on the rise, exposing consumers to those risks.
- The incidence of high individual interest rate surcharges is increasing . Reasons include the advent of risk-based capital requirements and individual credit risk pricing policies for mortgage finance, as well as the push to increase the subprime mortgage sector and reduce social rental housing. As discussed before, there is a thin line between credit risk prices that produce tolerable debt service levels commensurate with higher credit risks, and those that produce self-defeating results by triggering greater numbers of defaults as a consequence of excess burden imposed on borrowers.

[37] In non-Euro-zone, interest rate risk is partly still elevated. Britain for example is pushing for greater protections of consumers in the form of fixed-rate mortgages as a result.

- With strongly growing mortgage markets and rental markets under desubsidisation and denationalisation pressure, consumer heterogeneity in Europe is rising. This produces greater incidence of cognitive dissonances, lack of financial education and access to information, as well as income and employment risks.
- Insufficient borrower equity, a main trigger of solvency crises (notably in the UK in the early 90s), has become a problem again in many member states as average loan-to-value ratios rise especially in countries with inflated house prices to support affordability. The situation differs strongly, though, between member states, as does the house price risk picture.
- In a related context, misspecifications of property valuations have made historically major contributions to consumer solvency. In several European markets, as of 2005 implied yields in house prices are far below comparable quality rent levels, indicating the presence of a house price bubble. Buyers in such bubble situations are prime candidates for default and overindebtedness.
- Tax inducements for higher leverage or investments mainly for tax purposes on the whole have declined, with Sweden, Germany and the UK limiting or eliminating tax support for mortgage finance. However, some countries, prominently the Netherlands and to a lesser degree Denmark, continue to boost leverage through tax policy. While the Netherlands, with a 55% homeownership rate has a 120% GDP mortgage market, the UK with a 65% homeownership rate has only a 65% GDP mortgage market. Those mechanisms lead invariably to problematic financing constructions, including non-amortising or even ballooning loans and loans repaid by dubious amortisation vehicles. Residual debt is therefore a real issue.
- As far as enforcement is concerned, the enforceability of mortgages has been steadily improved over the past decades of strong market growth, especially in traditionally lagging countries in Southern Europe. However, as the British example of repossession shows, excellent enforceability does not necessarily help in a crisis situation, and greater degrees of freedom to restructure as well as liquidity in properties sales, whether free-handed or through auctions, are conducive to minimise residual debts. There are still apparently substantial risks for consumer solvency embedded in existing foreclosure regulations and processes.

What has been the consumer protection response to these risks affecting consumer solvency, especially considering the draft CCD proposal and national legislations? How does that response compare to financial regulation, which tries to protect bank debt investors from the impact of investing in questionable consumer risk?

- The way the European consumer protection, as witnessed by the FG recommendations, addresses mortgage interest rate risk seems to present a clear example of a policy lag. An obvious example is the antagonistic debate on restrictions on yield maintenance prepayment indemnities, which were historically imposed in the high-inflation phase of the 1970s. In the current EMU risk environment, those constraints make little sense from the perspective of consumer vulnerability and risk exposure. In contrast, reasons to worry about the interest rate risk impact on solvency exist in countries with incomplete markets, especially those without fixed-rate mortgages. The development of fixed-rate mortgages seems to be less a concern for consumer protection groups in the affected countries, who have been focusing on calling for mandatory caps for adjustable-rate contracts. However, financial regulators and independent reviewers have started to express such concern.[38] It is fair to say, though, that financial regulation, being broadly national, has not dealt with the issue of interest rate risk protection instruments in much detail. Basel II, for instance, does not require capital differentiations between adjustable- or fixed-rate instruments and under the internal-ratings based approach only requires a portfolio-wide review of default risk.

- Almost unnoticed by the European consumer protection debate, in several member states mortgage contracts denominated in low-rate yet appreciating foreign currencies, such as the Japanese Yen or the Swiss Franc are strongly on the rise. In Poland, Hungary, and for a short time in Austria, these were the dominant instrument type in the market. Financial regulatory response has been limited to Austria, which requires greater disclosure coming with such contracts. Consumer protection legislation apparently has not been active anywhere in the EU.

- European consumer protection regulation response to usurious individual contract rates and terms has been intense historically.[39] Over time, hard usury ceilings were replaced mostly by court determination of abusive practices or relatively lenient multiple of or mark-up over the applicable mortgage rate.[40] The CCD proposal is silent on the issue, while imposing under the unfair terms article limits on adjustments of contract rates, which could well under Basel II be justified due to changes in credit standing. It would seem that this approach would not be sufficient to contain consumer insolvency risk already in the near future.

[38] Examples are the UK Miles Review (HM Treasury 2004a) calling for fixed-rate mortgages in the UK and the introduction of special capital reserves by the Bank of Spain in order to provide for the possible solvency impact of a reversal of the interest rate trend.

[39] Usury is the oldest topic of consumer protection. The canonic prohibition of taking interest was lifted in Europe only in the 16th century. Until the 20th century, usury ceilings were mostly the only element of material consumer protection.

[40] See above and H.M. Department of Trade and Industry (2004).

- Paradoxically, traditional consumer protection law almost blanks out standard credit risk factors in prudential regulations of financial institutions:
  - Borrower equity constraints intended by imposing loan-to-value ratios seem irrelevant for the European consumer protection debate, or are hidden in general responsible lending clauses. In contrast, a consumer signing up to a 100% loan-to-value ratio is of specific concern for financial regulators anywhere in Europe as a potential bad risk for lenders. Regulators will impose LTV constraints or at least differentiate capital requirements for the lenders.

Table 3: Intensity of Regulatory Response of Consumer Protection and Financial Regulations to Consumer Solvency Risk Factors

Risk source	Solvency impact on consumer	Intensity of regualatory response in Consumer Protection	Financial Regulation
UNDERWRITING			
Interest rate risk and protections	Moderate (Eurozone)	Intense	Isolated responses
Foreign-exchange risk	High	None	Intense
Consumer heterogeneity	Moderate	Intense	None
Usury rate levels	Moderate	Intense	None
Insufficient borrower equity	High	Isolated responses	Intense
Tax-induced investment	High	None	None
Misappraisal of property	High	None	Intense
ENFORCEMENT			
Collateral enforceability	High	Intense	Intense
Amicable solutions	Moderate	Intense	None
Maximal recovery value	High	None	None
Residual debt discharge	High	Intense	None

Note: author's assessment.

  - Also, the problem that a house buyer might be purchasing a house at 'market values' in a market that demonstrably no longer prices properties in connection to fundamentals, such as rental yields, was traditionally underrated. Only at a late stage of the FG discussion, consumer groups intervened in a proposal that allows full choice of valuation method under a home country control principle. Basel I had introduced a risk cushion concept from the lender's perspective, the mortgageable value that is enforces a long-term perspective on value. However, its use even in the financial industry is optional.

- The apparent exception in the consumer regulation sphere seem to be risks involved in using investment vehicles to amortise mortgage loans. This is now an element of the CCD proposal (Article 28). However, the main driving factor behind creating those financing structures, misguided tax support policies, are not addressed. Financial regulators seem to be equally indifferent to such risk factors, which are considered to be outside their ambit.

- On the enforcement side, the European consumer protection debate has been traditionally very active and imposed procedures to which financial regulators can only react. Discharge is now universal, as are – in contrast to the US– pre-foreclosure arrangements that should avoid a forced sale and ideally result in debt restructuring. However, the focus seems to be still insufficiently on maximising the recovery of the loan, and thus minimising residual debt, through optimal sales proceeds on the property. Here, judicial procedures continue to be grossly inadequate, and institutional constraints on the pre-foreclosure regime continue to exist. Also, discharge has proven to be a double-edged sword through abuse, producing costs payable by the entirety of mortgagors.

Table 3 summarises our assessment of consumer protection and financial regulation approaches to the main risk factors and identifies the discussed gaps.

The conclusion is that traditional European law making in consumer protection is not based on sound economic principles and often at variance with good practice in financial regulation.

However, concern for lenders investing in a bad credit risk and consumer vulnerable to insolvency should be two sides of the same coin. Hence, any two approaches to contain either consumer vulnerability or lender credit risk should follow the same methodologies and address the same risks.

A risk-based approach to material consumer protection regulation

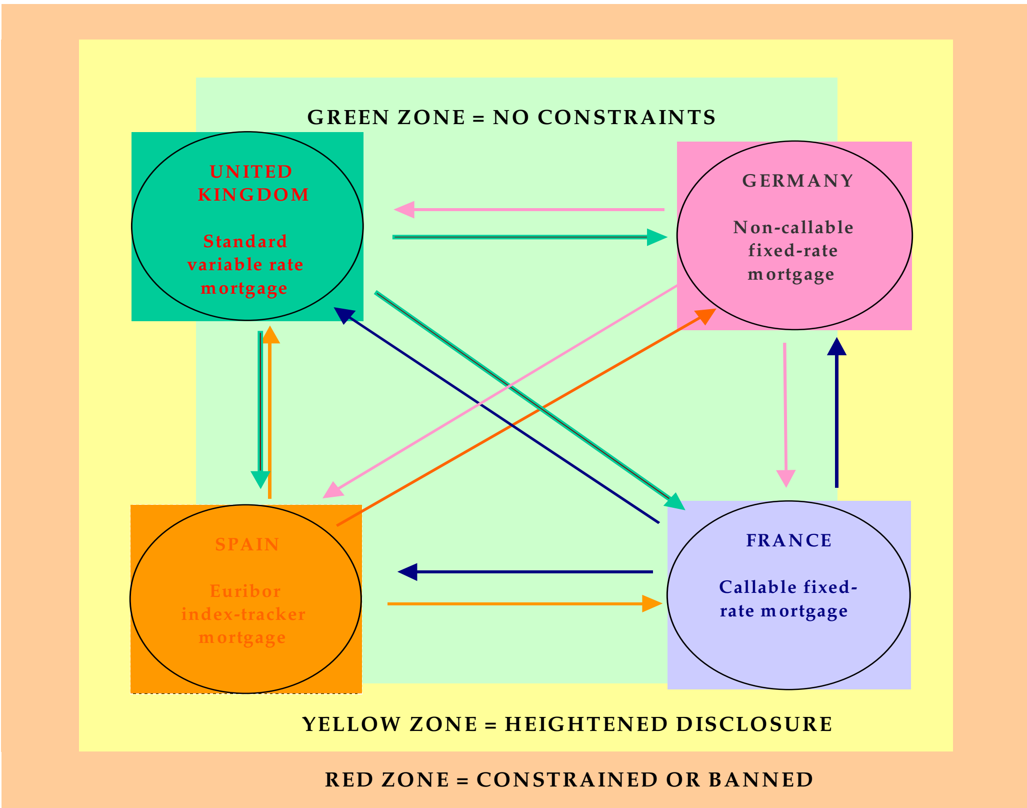
How could the inconsistencies and gaps identified be addressed? The answer for consumer protection should lie in pursuing the same approach as financial regulation, which involves the search for objective risk measures, risk classifications and a graduated regulatory response to risk. In the financial regulation sphere, these efforts are enshrined in the principles and procedures of Basel I/II or Solvency I/II.

Risk models suitable for risk classification from a consumer protection perspective would be based on the same methodology as the credit risk (or value-at-risk) models that are already applied by financial regulation. Primarily required for an adaptation is a differentiation by the main risk variables identified as drivers of default – the structure here would be richer than under Basel II.

On the other hand, in contrast to Basel II, there is less need to work with actual default data if the goal is a broad risk classification rather than a precise determination of capital. Simulations could thus be accepted that work with historical or hypothetical risk profiles. One would expect such simulations to show easily, for instance, that

- non-amortising loans (induced, for example, by mortgage interest deductibility from income tax) would have to be classified as riskier than amortising loans;
- fixed rate loans with prepayment option would be classified as less risky than fixed rate loans with call protection, which do not allow the borrower to prepay at par (but are cheaper instead);
- adjustable-rate mortgages would have to be classified as riskier than fixed-rate mortgages under most empirical circumstances, as would be foreign-currency denominated mortgages;
- loans underwritten with high loan-to-value ratios as riskier for the consumer than loans underwritten with low loan-to-value ratio.

Figure 6: Four-Country Sample – Conceptualisation of Risk-based Approach



Notes: green areas denote common market. Solid arrows denote legally admitted cross-border supply; broken arrows denote legally prohibited or prohibitively costly cross-border supply.

Clearly, where empirical data are available – an example would be the LTV aspect – that data should be used to calibrate empirical risk models.

The regulatory risk classification and graduated response should follow the empirical risk assessments. One option would be a traffic light system, with

- Green signalling the product universe subject to standard disclosure practices and no further intervention in the material protection field.
- Yellow signalling products with enhanced risk for specific vulnerable consumer groups. Such a classification would warrant heightened disclosure ('warning signs') or certain, problem-adequate restrictions, such as imposition of loan-to-value constraints. Essentially, when signing up on products classified as yellow, consumers would be informed about the additional risk they are taking in exchange for a likely lower price.
- Red denoting products that are considered risky for the typical consumer and in response could be restricted in offer, or in extreme cases banned.

In the context of the policies so far in the discussion, a Directive could be formulated starting from a maximin basis that allows as many products as possible. Maximin would essentially determine the green playing field.

However as a compromise with the minimax proposal and in line with the risk-based approach proposed here, governments could be entitled through a specific derogation of the maximum harmonisation approach to impose a graduated policy response on products considered as carrying increased or intolerable risk for consumers.

The form of response following a risk classification would be prescribed by the Directive, its verification require interaction with the Commission as regards to their adequacy to address the risk issue.

An example for such an approach is contained in the EU Treaty, where Article 87 describes the conditions of admissibility of state aid, while Article 88 formulates an interaction process of member states with the Commission under conditions defined in Article 87. An application of this competition policy approach to consumer protection could work as follows:

- Under a minimax formulation of the Directive, the main products in the EU would be tradeable in all member states.
- The national departments of trade and industry or similar relevant authorities would undertake risk assessments of the mortgage product menu offered, and classify those according to their risk content for the consumer. Existing consumer protection rules would be reviewed under this standard. The ministry would propose a graduated response to the Commission based on the empirical evidence collected, which may contain old and new regulation as well as elimination of old regulations.
- The Commission would, within a short time period, review the assessment and clear, or object to, the response scheme proposed by the member state. It would moreover compare notes of the empirical

evidence provided by member states in order to prepare for future additions, or changes to the Directive, if necessary.

Table 4: Risk-based approach to Material Consumer Protection – A Proposal

The European Union

- defines a methodology to estimate the (default/bankruptcy, retirement income) risk exposure of consumers that purchase certain mortgage products or are exposed to certain market practices.
    - This can be done for a large number of risk variables by calibrating standard consumer credit risk models (such as those used increasingly in determining bank capital requirements) with the applicable data.
    - For risk factors that are empirically difficult to quantify, data requirements can be reduced or replaced by other well-defined empirical methods.
- defines minimum material consumer protection rules on the basis of the empirical calibrations. Such rules are reviewed regularly (e.g. every 5-10 years).
- adopts a Mortgage (Consumer) Credit Directive under the maximum harmonization approach containing those as well as consumer information rules (see above).
- in the paragraph of said Directive defining maximum harmonization allows for
    - autonomy of the Member State to require from lenders heightened disclosure for certain products or practices (yellow area in Figure 6)
    - an appeals process for the Member State to the Commission to allow for stricter national material consumer protection rules for certain products or practices (red area in Figure 6)

  based on well-defined parameter constellations of the commonly applied risk model(s) and other empirical methods.

The Member State either

- accepts the set of material consumer protection rules on the maximum harmonization basis, i.e. eliminates more far-reaching legislation, or
- appeals to the Commission for setting stricter national rules, providing empirical evidence within the methodological framework provided by the Commission that demonstrates the harmfulness of certain products or practices to consumers justifying those stricter rules. Again, those rules are subject to review on a regular basis.

Source:author's assessment.

Coming finally back to our four-country core product sample, based on existing empirical studies, such a policy could work out in practice as follows.

- The German non-callable fixed-rate core product carries certain risks for the consumer if interest rates fall strongly and permanently. These are not related to the indemnity level, which would simply be capitalised into a new loan as the loan is prepaid, but to the possible mismatch between house prices, wages and interest rates over longer terms. It would probably be appropriate to categorize the product into a heightened disclosure regime. Still, consumers would be attracted to the product through its low costs.
- The British core product does not adjust rates according to an objective base index, which creates degrees of freedom for the lender to lag adjustment in an interest rate decline. However, lags were not significantly enough empirically to justify material constraints to be placed on the product. Moreover, they have to be seen in the context of pricing policy, which favours new borrowers. Again, in this circumstance a heightened disclosure concept could be an appropriate regulatory response.
- The Spanish core product, index tracker, is similarly exposing consumers to risk due to the high volatility of the base index – usually Euribor. In fact, as of 2005, Spain has the lowest mortgage rates in Europe, triggering increasing levels of indebtedness. The rate situation might change soon in an index-tracker, even more so than in an SVR where lenders may be able to cushion some of the rate increase to avoid soaring defaults. So, again, the consumer should be warned against that particular risk. As the UK default crisis of the early 1990s suggests for both types of adjustable rate contracts, it might be relevant to consider loan-to-value constraints in situations of extreme rate levels for particular groups of clients.
- The French core product seems to be the least risky from the consumer perspective, however, as the MOW study shows it is also one of the most expensive because of the prepayment options costs involved. Its price will rise if France proceeds, as planned, with a reform of mortgage transactions costs. Thus, while the product would likely be in the green risk area, borrowers must be prepared to pay a higher price, which in any event is fully disclosed to them.

Broadening the view beyond the four country example, a tentative review yields that all European core products would fall either into the green or yellow area:

- The Danish market is complete in the sense that it contains adjustable, callable fixed-rate (with prepayment option) and non-callable fixed-rate products. The adjustable rate product is typically offered with caps, so would in most circumstances fall into the green category.

- Product menus in Belgium, Italy, Portugal, and Greece are broadly comparable to the French/Spanish, product menus in Ireland to the British, and product menus in Scandinavia (except Denmark) and Austria to the German model.
- In the Netherlands, and to a lesser degree in other European countries, loans to be amortised through third party arranged constitution of capital have gained vastly in market share. Many of such arrangements would likely fall into the yellow category.
- Austria and accession countries in Central Europe, most notably Hungary, Slovenia and Poland, feature high, in the Polish case dominant, market shares of foreign-exchange denominated mortgage loans. Only the Austrian Central Bank has imposed heightened disclosure requirements on those types of loans in reaction to a swift increase in their market share.

Broadening the view beyond interest rate risk, a risk-based approach would be important especially in the area of direct credit risk factors.

An example would be the assessment of usury rules. In the case of risk-based credit pricing there is potential that actuarial assessments of default risk and consequent price mark-ups conflict with rigid statutory interest rate ceilings. Obviously, limiting price mark-ups could exclude some borrowers with low or volatile incomes from credit. This is particularly problematic in countries with scarce availability of rental housing as an alternative. On the other hand, as the history of the US subprime market would suggest , if those borrowers pay very high interest rates, they might be exposed to increased foreclosure risk, with the result of social costs in the form of overindebtedness and burden for the social security net.

Again, a graduated regulatory response based on a credit risk model could try to address both aspects; such an approach could avoid the mistakes made in the US, which ultimately triggered the re-decentralisation of consumer protection policy:

- Mortgage rates within a certain band over a statistical benchmark could be put into the green bracket (unless aspects of interest rate risk or other speak against this).
- A yellow classification and thus heightened disclosure or certain underwriting constraints could be placed on rates within a subsequent margin. The condition would be that, under normal underwriting conditions and income or property price risk conditions,

Obviously, finally, a candidate for yellow, heightened disclosure or underwriting constraints, would be high-LTV loans with empirically substantiated higher default risks. This is a risk dimension that so far plays, if anything, only a subordinated role in consumer protection regulations. The new CCD proposals seems to capture the particular aspect of constitution of capital, which is usually associated with non-amortising loans and high LTVs in the going concern, but otherwise remains silent on the issue.

Paradoxically, on the other hand many European national financial regulators have taken bold steps to reduce the credit risk banks might get themselves into through LTV constraints. Again, a graduated response approach to consumer protection might reconcile the consumer's and the lender's perspectives by putting loans with different LTV levels into different risk brackets, depending also on other parameters such as interest rate levels etc. Because of the specialist role of mortgage insurers, credit risk profiles in this dimension are probably the best documented in the mortgage industry, so the empirical task should be relatively straightforward.

In essence, the approach proposed here for consumer protection borrows from the Basel II empirical approach to risk based capital. There seems to be little reason, for instance, why assessments already made by proprietary credit risk models under the Internal Risk-Based Approach for banking regulatory purposes should not serve simultaneously consumer protection purposes. That service could be twofold – helping lenders, consumers and regulators to better understand the risks involved in mortgage finance, and avoiding unnecessarily harsh restrictions on the internal market.

Legal and collateral issues

Forum Group approach

The FG studies various legal reform areas, with a focus on property law, property valuation rules, credit databases and foreclosure.

While these are important primary market issues, there seems to be little conceptual clarity about the future European legal architecture in the mortgage sector. FGR 19 and 21 are the only assessments that take this broader perspective: FGR 19 demonstrates an agreement on the basic principle of *Lex Rei Sitae*; however, disagreement on the main norm guiding private law contracts, the Rome convention remains. This aspect has been discussed in the context of consumer protection before.

The FG proposals surrounding credit databases refer primarily to studies into their assessment and further encouragement, and ultimately target the creation of public goods of positive databases and cross-border access. How this should be funded is unclear.

FGR 24-27 again open the debate on mutual recognition, this time in the area of property valuation. Interestingly, the lender majority seems to support mutual recognition here while calling for (maximum) harmonisation in the consumer protection area.

Notable is also the hands-off approach to cross-border enforcement of collateral in FGR 28 and 29: here, monitoring - again a public good with open financing questions - is preferred without initially over regulatory action. A second observation is the general notion that different legal enforcement concepts per se are not the problem but rather enforcement time, an indirect approach to control infeasible enforcement concepts. The 2002 CCD proposal, however, goes beyond the FGR in calling for a ban on the use of bills and exchanges as substitute securities (Article 18), imposing strict information requirements for arrears management (Article 24), regulating repossession of leased goods in favour of consumers having paid more than a third of the purchase price (Article 25), and putting constraints on recovery attempts outside the judicial process (Article 26).

In the collateral law arena, the FGRs reflect broad agreement on the need to improve registers and thus the quality of the mortgage in many jurisdictions. This has not always been clearly articulated by the industry, which appeared for a long time to be satisfied with local solutions covering shortcomings of the mortgage concept, such as guarantees or leasing (France).[41] The FGRs 36-39 also reflect the growing recognition in many member states that inflexible property law structures have to be adjusted to the requirements of a more mobile population willing to switch properties and lenders more frequently, and to allow increasingly complex secondary market arrangements. The call for the Eurohypotec is the clearest expression of this desire, and will be discussed below.

The improvement of processes around collateral registration are also high on the FG agenda:

- the call for (better formulation and cover of) public guarantees in FGR 33 is certainly relevant and consistent with latest reforms of the Anglo-Saxon Torrens system[42] that seek to develop actuarially priced and capitalised guaranty funds and contain the onslaught of US style private title insurance schemes.
- The concept of a register representative (FGR 37) should also help to reduce transactions costs by creating a more effective interface between lenders and registers.
- Moreover, the relevance of the EULIS initiative for efficient cross-border access to registry information is hard to overestimate (FGR 35).
- In contrast, it is noteworthy that the FG abstains from calling for a review of the role of notaries and other members of the law profession in housing and mortgage transactions. The fact that use of their services is mandatory and/or price regulated is a major contributor to transactions costs in several jurisdictions.

41 See EMF (2002) survey on mortgage collateral, which abstains from making such far-reaching recommendations..

42 An example for the creation of such an actuarial fund can be found in the Australian state of New South Wales.

Table 5: Assessment of Forum Group Recommendations 19-39, Legal and Collateral Issues

Forum Group Recommendation		Type	Stakeholder Positions	Benefits for Integration	Benefits for Domestic Efficiency	Implementation Costs	Benefit/Cost Relation
LEGAL ISSUES							
19	Enforce Lex Rei Sitae	Regulation	Agreement	Moderate	High	Low	High
20	Amend Rome Convention to allow for free choice of law	Regulation	Strong disagreement	High	Low	High	Low
21	Retain Rome Convention as it is	Regulation	Strong disagreement	High	Low	High	Low
22	Collect information on credit databases	Study	Agreement	Low	Low	Low	Moderate
	Facilitate access/comparability	Public good	Agreement	High	Low	Moderate	High
	Parallel assessment project	Study	Agreement	Low	Low	Low	Moderate
23	Study encouragement of positive and negative databases	Study	Agreement	Low	Low	Low	Moderate
24	Accept property valuations of choice, if internationally accepted	Regulation	Disagreement	High	Low	High	Moderate
	Enable use of appraisers of choice	Regulation	Disagreement	High	Low	High	Moderate
25	Mutually recognize mandatory property valuation standards	Regulation	Disagreement	High	Low	High	Moderate
26	Ensure neutral or single valuation standards	Regulation	Disagreement	High	Low	High	Moderate
27	Make high valuation standards mandatory	Regulation	Agreement	High	Moderate	Moderate	High
28	Evaluate forced sale procedures	Study	Agreement	Low	Low	Low	Moderate
	Monitor and create scoreboard	Public good	Agreement	Low	Moderate	Moderate	High
29	Thereafter, if necessary, regulate foreclosure duration	Regulation	Agreement	Moderate	High	High	High
COLLATERAL ISSUES							
30	Ensure that all charges are registered	Regulation	Agreement	High	High	High	Moderate
	Changes effective only if registered	Regulation	Agreement	High	High	High	Moderate
	Rank of charges only as registered	Regulation	Agreement	High	High	High	Moderate
31	Ensure ranking based on reception of application	Regulation	Agreement	High	High	High	Moderate
32	Enforce transparency of registers	Regulation	Agreement	High	Moderate	Moderate	High
33	Enforce public indemnity or applicable professional liability for registration	Regulation	Agreement	High	Low	Moderate	High
34	Disallow additional legalization requirements	Regulation	Agreement	High	Low	Moderate	High
35	Support EULIS cross-border registry access initiative	Public good	Agreement	High	Low	Moderate	High
36	Weaken link between collateral security and mortgage debts	Regulation	Agreement	High	High	Moderate	High
	Replace strong accessoriness by security agreements	Regulation	Some disagreement	High	High	High	Moderate
37	Enable Register Representative	Regulation	Agreement	Moderate	High	Moderate	Moderate
38	Study Euromortgage concept	Study	Agreement	Low	Low	Low	Low
39	Encourage pan-European Security Trust Instrument	Public good	Agreement	Moderate	Low	Moderate	Moderate

Note: author's assessment

Selected issues

Property valuation

Issues and evidence

For several European markets arguably house price bubbles constitute the greatest consumer risk exposure today. The latest Economist global house price review shows that in Britain, Spain, France and Italy house prices are now clearly divorced from underlying scarcity trends in the housing sector, as reflected by rent development.[43] Yields on housing investments are on a historical low, raising the likelihood of a price implosion as interest rates rise.

This situation, which is not new to Europe and already has been associated in the past with mortgage credit default waves[44], clearly raises the question of appropriate valuation standards for residential housing. Such standards are central for both consumer protection and financial regulation.

The valuation practices in Europe that FGRs 24-27 refer to are in fact characterised by wide divergences, as the recent EMF report on property valuation covering 13 member states shows.[45] Particularly problematic are the following aspects:

- The concept of open market value (OMV) dwells on the crucial assumption of efficient property markets, in parallel to the efficient market hypothesis in securities markets. Doubts are justified whether this hypothesis is tenable for the property market:
    - The fact that regularly imbalances arise between yields implied by OMV and long-term financing cost levels is likely a sign of inefficiency. Any such difference reflects capital growth expectations, which ought to be justified by some argument explaining permanently higher scarcity levels of the good financed. Empirically, however, European house prices have always come back to a flat long-term trend.
    - Economies that heavily rely on OMVs also seem to suffer from pronounced conflict of interest of appraisers and brokers, who are remunerated in proportion to property sales turnover, in dealing with consumers. This incompatibility of incentives has been of concern for the UK government recently in the case of real estate agents.[46]
    - The mortgageable lending value (MLV) in contrast, exists as the EMF study shows only as a crude concept on the European level but not as a feasible and universally applicable valuation method. This triggers understandably opposition from proponents of efficient property markets and OMV. In theory, MLV in retail finance in Germany as laid down in the valuation ordinance is supposed to reflect only permanent characteristics and marketability of the property. In practice, German lenders simply apply haircuts from OMVs or contract values to arrive at MLVs.

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43 'Global house prices', The Economist, March 2, 2005.

44 Strong house price cycles occurred already around 1990 in several European jurisdictions, including Britain and France, with subsequent credit problems in particular in Britain.

45 See EMF (2004).

46 See OFT (2004).

Regulation options

The focus on property valuation in the FGR is indeed justified and the dynamics should be channelled into a high-level debate about European valuation standards. Consumer groups should be invited to more actively participate in that debate than in the past, since valuation is a genuine consumer protection issue. Central to any regulation attempt would be a clarification of conceptual issues and an agreement on a harmonisation approach.

Conceptual issues:

- A further development of the MLV on the European level seems to be a sine qua non. As the concept is presented by the industry at the moment, it is neither operational nor free of controversy. The practical difference to OMV is moreover too small in retail finance to matter. A solid conceptualisation of an MLV should dwell on a cash-flow pricing model for housing that provides sufficient conservativeness to support affordability of consumers and reduce risk for lenders. Cash flow pricing is already the standard for income-generating ('commercial') properties. For the retail market, specific valuation formula ought to be formulated that are calibrated by imputed rent statistics, ideally a full rent model. Cash flow formulae need to seek to contain speculative elements by imposing minimum yields reflecting long-term financing conditions[47] and taking a sufficiently long-term perspective on rental data.
- A better regulatory structure for the OMV in retail finance seems also necessary. The current practice of self-regulation by the profession is not sufficient due to the conflict of interest arising from the fee structure. Standards should cover the quality of housing transactions databases and interpretation or if necessary haircut requirements for recorded data, for example small volumes behind transactions as typical for bubble situations. Concerning ancillary services, changes in the fee structure could be sought along the lines of a recent UK OFT report.[48]
- To truly anchor the long-termism of valuations and address catastrophic risk situations, the replacement cost method should always be considered as an anchor for a menu of valuation techniques, which it is currently only in Sweden.
- Steps should be taken to address the general dearth of transactions databases in the retail property market, which is a serious impediment to better valuation across Europe.

47 Minimum yield requirements are imposed on MLV computations for commercial property in Denmark and Germany, for example. This is not the case for retail properties, however.

48 See OFT (2004).

This list already shows that there cannot be a 'single' valuation standard (FGR 26). In fact, a parallel use of OMV and MLV is most useful. It would create an incentive-compatible structure for lenders vis-à-vis consumers. The difference between the two, in essence, should reflect the call option value of cashing in a capital gain in the future, which is the consumer's only. Confining lenders to the MLV would reduce the cyclicality of lending by automatically increasing the gap to be financed by borrower equity should OMVs rise, and address the fundamental risk asymmetry: after all, the consumer may reap a capital gain from selling at a high price, while the lender writes a put option for the consumer on the house, if house prices fall below the outstanding mortgage claim.[49]

The alternative, to render loan-to-value constraints for lenders endogenous based on OMV valuations could be an option in principle, too. However, it carries the dangers of policy lags of several months, depending on data availability, and thus potential pro-cyclicality. Moreover, it does not remove the task of assessing the long-term viability of a debt financing position in housing.

Harmonisation approach

As indicated in the FG report, the mutual recognition of valuation concepts is in fact the only practical solution in the short-term. However, this should not be misunderstood as a permanent acceptance of weak standards or conflict of interest of providers.

Lenders' argument that local valuation standards are 'accepted' by international investors, for example in the case of mortgage bonds, seems dubious in that regard. Rating agencies have not been known for a particular eagerness to reduce local idiosyncrasy, since their core business is to explain and condense that local idiosyncrasy into a rating comparable among jurisdictions. In addition, a rating is an amalgam of various credit factors, in which property values play but one role. In practice, interventions of the agencies are understandably confined to process issues, not fundamental aspects.[50]

The proposal to develop European appraisal standards as optional is valuable in that regard. As in other areas, the hope would be for high-quality standards that could eventually replace local ones on a maximum harmonisation basis. European standards should clearly contain both OMV and MLV.

To summarise, the mid-term policy goal should be to arrive at Europe-wide accepted calibration and computation standards for individual valuation concepts, not a uniform valuation concept. The practical implementation of

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49 The value of that put option for the consumer depends in addition on the foreclosure regime and residual debt treatment.

50 See Fitch (2003) which surveys different processes now practiced in the UK

such standards may differ primarily according to local data availability, which affects calibrations. Whatever the approach, it would be important to develop the consumer protection and financial regulations in parallel and consistent with each other.

Accessoriness and Euromortgage

Issues and evidence

The historic European legal tradition of accessory mortgage instruments, that is, instruments that display strong ties or even identity between loan and security agreement, is widely held as incompatible with the financing requirements of residential mortgage finance of today.

The point is that the simple financing situation of 'one borrower, one loan, one property and one bank' is no longer typical for a market characterised by product innovation and mobility:

- Changes in loan conditions, even if agreed in advance in nature, may conflict with strict accessoriness – legal questions are raised in the cases of reset fixed-rate and adjustable-rate mortgages.
- Bank and borrower may want to agree on changing the loan amounts during the contract duration - examples are flexible mortgages and home equity loans. While alternative concepts with limited accessoriness exist in most jurisdictions to enable those products, these again often lack flexibility and certainly differ across jurisdictions.
- Borrowers may want to pledge several collateral items for one and the same loan – so-called 'joint mortgage'.
- Borrowers may want to change the purpose of the loan, for example from financing a house to pledging the house as collateral for a small business or consumption purposes.
- Borrowers may want to prepay and refinance with the same or another lender – strict accessoriness may impose problems such as seeking the consensus of the old lender and in any event re-registration costs of a new financing.
- Borrowers may want to sell the house and transfer the mortgage to a new borrower.
- Lenders may want to assign loans or servicing to new investors or seek co-financing through syndication.

In the pure form, the close link of loan and security agreement requires the re-registration of the accessory mortgage for most of the above purposes. Registration triggers costs for lenders and borrowers, which may be very high depending on jurisdiction

A second cost block is independently from national functionality imposed on cross-border lenders. With varying legal regimes, and in particular legal uncertainty, costs of analysing the legal situation may quickly exceed tolerable levels.

Regulation options

The arguments presented above are hardly contested by the FG or in national discussion, although an empirical calibration is very hard to come by. However, different European states seem to draw different consequences. Currently, there are basically three different approaches:

- Gradual remedy of the negative consequences of accessoriness, by either creating overriding legislation or limiting the degree or impact of accessoriness. These reform processes are underway in most European jurisdictions.
- Introduction of an alternative concept that limits or eliminates the accessoriness and creates a 'clean' legal architecture with respect to the abovementioned (and other cases). This is the thrust of the Eurohypotec proposal, which is based on a land charge concept[51] and is the basis of the regulation proposal in FG 36 and the call for further studying in FG 38.
- A third route would be a far-reaching reduction of transactions costs associated with re-registering an accessory mortgage in the cases discussed. Examples of vastly varying costs are presented below – these hinge on the extent of formality, counselling and extent of registration requirements, on the requirements for third-party technical expertise involved – especially notaries, on the costs of the technology underlying the registration, and guarantee costs for the correctness of entries. Clearly, cost savings potential can be identified in all those areas. However, given the slow actual change, this could be realised only in the long-term.

Clearly, removal and even gradual reform of basic legal concept of mortgage finance on the national level raises problems of compatibility with other legal areas, including enforcement/insolvency legislation, consumer protection legislation and banking legislation, to name but the most important. Moreover, according to the EU Treaty, property law and much of the affected fringe laws is fully in the ambit of the subsidiary.

The Eurohypotec is therefore mainly interpreted as an optional add-on to the existing security concepts, which must be tailored to fit the national legal system according to necessity.

Benefit-cost assessments concerning the Eurohypotec proposal are not available so far and should be subject of future research (see FGR 38). To sketch some relevant areas:

51 For an introduction to land charge and Eurohypotec see Stoecker/Soergel (2002).

- Relatively easy to assess are high transactions costs introduced by some national security concepts (frequent need to re-register mortgages, use notaries, etc.).[52]
- A second area is the costs of implementing the plethora of derogations with the sole purpose to render accessory instruments under certain circumstances fiduciary. Those are mostly in the interest of the lender, and rarely of the consumer. Well-known examples are securitisation laws whose main purpose is often to enable loan transfer in case of accessory mortgages (for example in France and Spain).
- Moreover, the reduction in consumer and lender optionality in both primary and secondary market operations through accessoriness may be substantial. For example, fiduciary instruments can be used by consumers to support new claims and thus enhance their credit or to attract various creditors for a single investment.
- Generally, greater use of a more flexible mortgage concept would add to credit supply. Consumers that are constrained in their ability to pledge collateral for loans (also rental contracts) generally face higher lender demands on solvency and cash flow coverage.
- The costs imposed on cross-border lending are substantial in the case of accessory mortgages. In a cross-border transaction fiduciary instruments can be simply assigned by the borrower to a new lender without having to seek the consent of the old lender (significant facilitation of the secondary market).

A complicating factor is that the speed of the baseline case of 'perforation' of accessory mortgage at the national level to achieve greater non-accessoriness is not clear. Legal reform tends to be lumpy and asynchronous between member states, followed by longer spells of inactivity. Steady progress towards removing the financing transaction obstacles, and in particular reducing the associated transactions costs, could be equivalent to the introduction of the Eurohypotec. But this scenario is hardly realistic.

In this context, the case for a simple and consistent European concept for actual or potential cross-border trade or the efficiency of individual national markets themselves should be quite strong; at least further evaluation is justified.

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52 Consider the financing situation of mortgage prepayment. Dübel and Lea (2000) estimate the size of the break-even interest rate decline that would make prepayment feasible from the borrower's perspective. The template is a 10 year loan with a 7 year residual duration (i.e. prepaid after 3 years). With comparable processing costs for the new loan agreements and low prepayment indemnties, French borrowers, which are forced to re-register mortgages with the involvement of a notary, needed a 179 bp rate decline to break even while their US counterparts, with similar accessoriness of the mortgage but without notary involvement requirement, needed only 74 bp. For Danish borrowers with low re-registration costs prepayment would already have been advantageous after only a 42 bp rate decline. Interviewed German lenders assumed even lower break-even points to the widespread use of the land charge.

Assessment

A proper legal architecture of European mortgage market reforms will be central for gaining support for reforms. Technically and conceptually, the pieces of reform must fit together and leave sufficient degrees of freedom, both on EU and subsidiary level, to react to market developments. The FG recommendations offer individual elements of law making, but no proposal for a consistent legal architecture. There are three central legal policy dimensions for the mortgage sector:

- Type of harmonisation. The principal options were discussed above for a convenient illustrative case, and a case was made in favour of maximum harmonisation in the consumer protection area with strong empirical foundations and an appeals process for national legislation in analogy to Article 87/88 EU Treaty. This may generate a valid compromise between the 'maximin' and 'minimax' extremes, which have lead to political allegations of excessively 'lender' or 'consumer' friendly legislation as well as excess bureaucracy creation.
- EU regulation vs. subsidiarity. The mortgage sector is a textbook case demonstrating that the statutory limitation of the EU regulatory ambit - essentially to capital markets and parts of mortgage market regulation – generates inadequate treatment in a sector that spans almost all legal spheres. The classical case is housing market law, especially rental law – as the CCD defines mortgage rate adjustment formats, there is no comparable legislation for the central relative price of the housing sector – rent. Two other critical areas are property law, which is subsidiary to the degree that some member states have delegated authority to the subsovereign level (for example Germany), and enforcement law.
- Need for public goods. Any legal development strategy requires strengthening institutions and technologies. Property registries, consumer databases, redress and ombudsmen, out of court settlements, freehanded property sales, proper auction processes, and courts are particularly important areas for the mortgage sector. As subsidiaries have gone to great lengths to improve on their existing institutional structure – examples are the efforts in the UK - the EU has no direct means of influencing institutions on the subsidiary level.

Emphasis should be laid going forward on how the regulatory ambit and institution development issue can be more properly addressed. A central option would be to strengthen core groups of member states willing to proceed in a certain area, with Commission support. Good examples here are the EULIS initiative and the Eurohypotec proposal:

- In the case of EULIS, sufficiently technologically advanced and legally comparable public registers are creating enhanced access conditions. Such projects gain own dynamics by putting a spotlight on the less developed register systems, either due to technological gaps (Belgium) or legal problems (Germany) or both (France).

- In the case of Eurohypotec, a similar approach is in place, with another country group constellation pooling lenders particularly interested in cross-border business. Again, this initiative is expected to develop an own dynamic, once lenders (and consumers) discover the additional degrees of freedom under an advanced legal structure.

A second central option is to establish a European monitoring process concerning deficiencies of the legal system and thus exercise indirect pressure on subsidiaries to reform where those are beyond the ambit or warrant a delay enabling subsidiary adjustment before the EU takes action. This is the approach taken in the case of enforcement and could be a model for other areas, especially as far as public goods are concerned (registries, databases).

Distribution and finance

Forum Group approach

FGRs 40-48 deal with industry structure issues in the areas of product distribution, risk management and funding on a very selective basis. The associated policy areas, competition and financial regulation policy, happen to be among the most active at the EU level.

Competition policy

FGR 40 calls to ensure equal treatment of local and foreign banks. Generally, the thrust here seems to be the widespread political engineering of national banking champions and preference for domestic restructuring and mergers, which has made cross-border mergers and acquisitions extremely difficult and rare events.[53] In fact, the European mortgage market is in a situation where capital is available in excess in some jurisdictions, while scarce in others[54], without an operational cross-border investment channel. The issue is exacerbated by the strong capital release mortgage lenders can obtain under the IRBA approach of Basel II.

It is interesting in that regard, and perhaps explained by the composition of the group, that unfair domestic competition, for example through public ownership or guarantees, is not mentioned as a recommendation.

The FG discussion also underlines that product innovation is a major entry channel and that competition policy should safeguard it by avoiding excessive standardisation. In that regard, FGR 41, concerning removing restrictions on the opening of representative offices, an area not covered by EU legislation, seems obvious.

FGR 42 in contrast proposes to supervise intermediaries, which is likely to be controversial. On the one hand, securing the independence of intermediaries,

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53 Recently, much attention has focused on cases in Italy and Spain.

54 The UK is an example of the former case, Germany an example of the latter.

which are indeed main facilitators in cross-border market entry, is an important competition policy tool. Examples are the Netherlands and Germany, where large multi-client and –product brokers are pivotal in helping foreign lenders (as well as domestic entrants) to distribute their products in a new market and both gain scale and pricing experience. On the other hand, suspiciously, no intermediaries were represented in the FG, so that supervision proposal is likely to be met with scepticism.

FGR 42 concerns the supervision of intermediaries. This is an important aspect, since independent intermediaries may indeed foster cross-border market entry.[55] Suspiciously, no intermediaries were represented in the FG and the supervision proposal is likely to be met with scepticism by that industry.

Table 6: Assessment of Forum Group Recommendations 40 – 48, Distribution and Finance

Forum Group Recommendation	Type	Stakeholder Positions	Benefits for Integration	Benefits for Domestic Efficiency	Implementation Costs	Benefit/Cost Relation
DISTRIBUTION ISSUES						
40 Ensure equal treatment of local and foreign banks	Regulation (enforcement)	Agreement	High	Moderate	Moderate	High
41 Remove barriers to cross-border representative offices	Regulation	Agreement	Moderate	Low	Low	Moderate
42 Supervise independent intermediaries	Regulation	Agreement	Low	Moderate	High	Low
43 Review legal barriers to internet use	Study	Agreement	Low	Low	Low	Low
44 Ensure consistency of Directives regulating financial products	Regulation	Agreement	High	High	Low	High
FINANCE						
45 Harmonize segregation of assets	Regulation	Agreement	High	Moderate	High	Moderate
46 Recognize bankruptcy remoteness of securitization vehicles	Regulation	Agreement	High	Moderate	High	Moderate
47 Remove tax distortions between domestic and foreign lenders	Study Regulation	Agreement	High	High	Moderate	High
48 Enable cross-border collateral pooling	Study Regulation	Agreement	High	Moderate	Moderate	High

Note: author's assessment

Financial regulation policy

On the financial sector regulation side, the FG recommendations focus almost exclusively on developing the secondary market, which is indeed currently the main cross-border channel in the mortgage sector in Europe. The list of recommendations thus is highly selective. They reflect primarily the perspective of bond issuers and MBS originators in the lending community.

[55] An example is Germany, where large brokers are largely operating on behalf of foreign lenders wishing to gain experience in the market.

FGR 45 demands a far-reaching harmonisation of the treatment of segregation of assets from bank balance sheets. In effect this means partial harmonisation of national bank bankruptcy laws that pursue widely varying approaches to preferences for pledged assets. Key stakeholders, such as deposit insurers and fiscal authorities (with respect to holding tax and other fiscal liens) are so far not involved in the discussion.

FGR 46 calls similarly boldly for recognition of bankruptcy remoteness of securitisation vehicles, even in the same financial conglomerates. Again this demand is highly problematic, since currently a nullification of any securitisation transaction may be legally pursued by a bankruptcy receiver or bank administrator in most European jurisdictions. Existing European securitisation laws address the issue, however, they are incongruous and create exceptions. Only the US follows currently a pre-commitment approach by the deposit insurer vis-à-vis bond issuers in the form of an agreement between the FDIC and the government-sponsored enterprise system in the secondary market. Conditions on such transactions apply, however, and fraudulent transactions can be contested by the deposit insurer.

FGR 48 calls for measures to facilitate the cross-border pooling of collateral, an issue that requires discussion with national regulators. Clearly, cross-border collateral pooling would generate strong integration benefits by enabling greater credit risk diversification. On the other hand, national regulators have made it clear that they see the review of collateral quality in the mortgage sector as under their authority and will pursue a case-by-case approach regarding the source country of the collateral. [56] This leads to a multiplication of review processes.[57] Relief in the area is understandably high on agenda of issuers that see the opportunity to gain rapid scale and diversification in the secondary market.

Assessment

Competition and financial regulation policies are, as the EMF-MOW study (2003) and Dübel (2003) have suggested, key areas of interest for intervention. This is partly due to their great relevance for integration – especially as they contain direct barriers to entry and subsidies – and partly due to the relative ease with which integration could be fostered.

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[56] A paradox in that regard is that public sector loan pools for instance in German *Pfandbriefe* are already broadly internationally diversified, because here the regulator seems to follow the stipulation that the access to EMU has levelled the credit risk. This is in our view a heroic assumption, and establishes discrimination vis-à-vis the mortgage sector.

[57] In theory the number of review processes is $n(n-1)/2$, where n is the number of member states.

Competition policy

Many instruments addressed by the FGR are in place, such as the EU Treaty and Takeover Directive, as well as numerous Financial Regulation policies that are currently condensed under the Lamfalussy process.

Stricter enforcement of existing EU entry regulations, in particular the Second Banking Directive, would be needed. This could occur, for instance, through a fast track extra-judicial complaint procedure and by imposing financial sanctions for violations by national governments.

However, takeover rules remain hotly contested, and as a result the implicit barriers to entry may continue to prevail for the foreseeable future. In that regard, enabling cross-border lending and insurance service provision in order to allow takeover of market shares as a weaker substitute for the actual takeover of institutions becomes even more pivotal.

Clearly there is broad stakeholder agreement that flagrant direct or indirect foreign entry barriers should be removed. However, in practice this is often lip service because national interest or interest in supporting a specific financial market place dominate. Policy issues include:

- More clearly formulated takeover rules that eliminate special voting rights, empower minority shareholders, transfer voting rights to all investors taking economic risk – in particular participation shareholders, and ease options for 'hostile' takeover
- Strengthening of anti-trust and corporate governance policies. Excessive domestic banking concentration is hard to address directly by national regulators, due to a conflict of interest between stability and competition. Unless a European regulator emerges which will be less exposed to that conflict at least initially (see below), the potential negative impact could be cushioned by stricter enforcement of existing European anti-trust regulations through the EU Commission. Current corporate governance initiatives should be furthered.
- The introduction of a single European financial services supervision agency (see also below)

The FG discussion remains suspiciously silent about subsidies. These are pivotal factors that steer competition and product innovation, hence integration. A more aggressive approach is advised, both towards lender and consumer subsidies. Instruments are at hand under the EU Treaty. In the area of lender subsidies, there are three priority issues:

- Limitation of equity funding subsidies, especially by defining a consistent regulatory framework for public and mutual banking. The stumbling block here is Article 295 EU Treaty, which ensures that the ownership order remains in the ambit of the subsidiary while not placing any constraints on that owners' behaviour.[58]

- Creating a positive list of admissible purposes for public bond guarantees. EU policies in the area are not only dominated by case law, but outcomes are also subject to political negotiation; there is a lack of clarity regarding guiding principles. National governments react by creating new guarantee channels, closing those opposed by the Commission.[59]

Moreover, the EU should move towards finding a common standard for consumer subsidies in mortgage finance. No formal interpretation of Article 87 (2) is currently available in the context of mortgage finance, which allows state aid to individuals with a 'social character'. To develop such an interpretation should be the subject of a White Paper or similar policy document. The priorities in this area are:

- Run a consistency check on admissible state aid to individuals between mortgage market policy and other policy areas.
- Improve the targeting of subsidies, along the lines of Article 87 (2), for example to prospective homeowners at the affordability threshold rather than to all homeowners.
- Protect borrowers from policies inducing excessive indebtedness caused by tax 'support' policies. This is a major issue in the Netherlands, Sweden (homeowners) and Germany (capital investments).

Financial regulation policy

FGRs 45 - 48 represent an industry wish list. To substantiate these proposals, the perspective of national, and sometimes group, deposit insurers and of fiscal policy makers would have to be sought and bank bankruptcy laws and procedures to be analysed in detail. Because all these ambits are clearly subsidiary, a European solution is highly unlikely for the time being.

However, the financial regulation area is among of the most active on the EU level and offers room for manoeuvre for the Commission to strengthen mortgage market integration and development.

Capital markets

As of 2005, almost every EU country has legislation for the main mortgage-backed instruments in place (covered bonds and mortgage-backed securities).

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[58] Interpreted to the extreme, Article 295 would allow a completely nationalized economy to become part of the common market.

[59] A striking example is the German mortgage market, where the *Landesbanken* will lose their debt funding advantages by 2005 while the federal agency KfW is increasing its role under a 'new generation' of projects, which might lead to a US style government-dominated secondary market in Germany.

However, some form of European instrument standardisation and pan-European issuer growth process would need to be organised to reap greater benefits from this situation. Greater liquidity for instance, as the EMF-MOW study has shown, is a vehicle with which both domestic efficiency could be improved and integration be furthered. Just consider the prospect of having a Europe-wide issuer of callable bonds that would refinance prepayable loans, a project which to the chagrin of consumer groups is currently only available in Denmark. In Europe issuers are currently too fragmented (more than 70, according to EMF count) to produce the necessary liquidity, standardisation and specialisation.

The most important lever would be action on the regulatory, infrastructure and tax conditions of the corporate, agency and mortgage bond markets, which are all relatively illiquid and so far not a focus of the FSAP.

- With the continued growth of the issuer base, through new issuer classes and new countries adopting legislation, common minimum standards for covered bonds are more urgent than ever. Article 22(4) UCITS Directive, which so far presented the de-facto standard, excludes many relevant issues and must be replaced. Short of a European Mortgage Bond Directive that has been opposed for three decades now by stakeholders, a specific definition should be sought, possibly in the form of an industry agreement. The EU Commission should be actively involved in brokering that agreement.
- Defining common standards for structured finance is similarly relevant. The European Securitisation Forum developed a policy document in 2002 that defined the main areas of standardisation. Clearly, action supporting a European MBS market will also help the mortgage bond market, in particular concerning the issues of proof of existence of claims, sale and transfer of assets, data protection and bank secrecy rules, rules governing bankruptcy and taxation (compare FGRs 45 and 46). Since this is largely outside the EU's regulatory ambit the EU could support comparative research in the area.
- Additional steps are needed to enhance the liquidity and strengthen the decentralised character of the European secondary mortgage market. These include European industry initiatives oriented towards deepening the secondary market in bonds, following the example of the Jumbo bond market developed by the German mortgage bank association in the 1990s. Again, supporting national regulators through research to move fast on FGR 48, the pooling of mortgage collateral of different jurisdictions, should be a priority.

Such measures conducive to standardisation and institutional restructuring of the secondary market would render an agency or government-sponsored enterprise model along the lines of the aborted European Fannie Mae proposal irrelevant.

Banking and insurance markets

Even though enforcement might be improved, as discussed above, little illusion should be harboured about the ability of national regulators and industries to defend their territory against cross-border mergers and market entry through implicit entry barriers, even if a satisfactory mortgage market programme under the maximum harmonisation principle could be realised.

This leads to a strong business case for the creation of a single European financial services authority that is remote from pursuing national interest, as is already the European Central Bank. Centralising European supervision could eliminate inconsistencies in current supervision, pool the best expertise in the financial sector, speed up legislative processes, reduce costs[60], and ultimately enable effective supervision of specialised European mortgage institutions, which is beyond the means of many smaller countries, notably the EU accession candidates. The single regulator is the unspoken consequence of the extended Lamfalussy procedure.

A second important dimension is continued development of bank regulation with a view on facilitating cross-border diversification and risk transfer.

- Less restrictive treatment of private sector provided credit enhancements and a stronger focus of capital rules on diversification effects would realise the risk mitigation effect of cross-border credit risk investment in mortgage finance. It could finally develop true economic interest in holding a pan-European mortgage portfolio.
- Also, stronger regulatory benefits should accrue to mortgage lenders, which intensively use traded instruments and thus subject their operations to stronger capital market supervision. This would acknowledge the desired strengthening of the third, market review pillar of Basel II. Under current formulations of the first pillar, the credit risk intermediation by capital market intermediaries in mortgage finance is penalised rather than acknowledged, an issue that has not been entirely removed by CAD3.
- Most importantly, advancing Pillar I capital requirements further towards economic risk would imply charging capital for interest rate risk exposure. This would provide incentives to banks to discontinue, or limit, mismatched funding of mortgage loans, lowering their solvency risk and thus the contingent liability of government and the subsidy content of the market. Depositaries would either sell fixed-rate loans in the secondary market, use swaps and other derivatives to hedge the risk, issue bonds, switch to offer adjustable-rate loans, or hold higher capital.

All these steps would bring the European market closer to the US example with its larger use of capital markets in mortgage finance.

[60] According to Koch-Weser (2003), in the EU there are currently 39 financial supervision authorities, and the typical cross-border lender has to deal with 20 of them.

Conclusions

Merits and constraints of a stakeholder group approach

While the author sees the usefulness of the Forum Group as a vehicle for forming stakeholder consensus, it would like to point to some shortcomings of the current approach.

First, stakeholder discussions or negotiations generally cannot substitute for detailed analytical and empirical evaluation of the issues at stake, which should form the basis of the discussion rather than vice-versa. While the FG has identified several areas for further review, as the discussion on material consumer protection shows these are often not the central ones for law making. That there is no scientific and only very little empirical basis risks leading to gross misunderstandings of issues - a typical example is mortgage prepayment, where one group of shareholders appears to believe that the prepayment option can be delivered free of additional costs.

Second, as the preceding several years of negotiations on the European Home Loan Code has shown, progress in pure stakeholder debates is very slow.

Thirdly, any stakeholder group has selection bias in one form or another, and the FG is not an exception. In this particular case,

- certain industry groups were not represented. An example is intermediaries, which may help to explain why the only proposal containing additional supervision was placed on this group.
- consumer groups were represented, but seem to have been too narrowly focussed on core issues of the CCD rather than the broader consumer protection agenda, which includes financial regulation, property valuation and competition issues.
- financial regulators were not represented. They clearly will have a say on the implementation of the proposals on property valuation and the entire area of distribution and finance. Again, due to the absence of this group, recommendations were made that will certainly be met with resistance (FGRs 45, 46 and 48) or denial (FGR 40).
- finally, fiscal authorities were not represented, which will affect the implementation chances of proposals with regard to the treatment of (statutory) liens (FGRs 30, 31), calls for public guarantees (FGR 33), taxation (FGR 47) and proposals for public goods that require financing (FGRs 9, 12 and possibly others).

Such selection issues would play a role depending on which areas the Commission wishes to harmonise. If the central issue is the CCD reform as presented in the 2002 proposal and 2004 amendment, the current FG seems reasonably representative.

Fit into a broader mortgage market integration and development strategy

How do the FG recommendations fit into broader integration and strategy that addresses both demand and supply issues of the mortgage market? To start with, such a strategy has not been formulated so far. While the London Economics study of 2005 for the Commission presents a hypothetical integration package, making detailed policy recommendations was not a goal of that study. However, it is useful to briefly review existing strategy proposals to see to which point the FG has brought the discussion, and which areas deserve modification or additional attention. The existing proposals suggest either comprehensive regulatory reform or central institution building at the EU level.

The EMF-MOW study provided the empirical background for proposals structured along the value added chain of mortgage finance. The focus is on regulatory measures and the creation of basic public goods, matching the FG approach.[61]

- Funding: the primary vehicle is the integrated European capital market allowing for greater standardisation and liquidity in funding instruments. Policies to support the capital market have already been the focus of the FSAP elapsing in 2005, but require further action in the case of mortgage finance as outlined above. Given the advanced stage of EU initiatives and the increasing convergence of interest of the mortgage industry in using capital markets, the implementation barriers should be low.
- Product innovation: enforcing competition policies should create ease foreign entry, which – given the currently strong differences in product menus - adds to product diversity, competition, market size and hence consumer benefit. The issue is clearly under the current regulatory ambit of the EU, but faces implementation obstacles due to objectively hard-to-solve regulation questions and strong lobbying.
- Risk management/insurance: different national residential mortgage portfolios tend to hedge against each other with respect to credit risk. Pan-European mortgage portfolios, supported by pan-European covered bonds or MBS or loan insurance are able to reap corresponding diversification benefits. Those should result in lower margins, or higher market penetration. The benefits are empirically not particularly large due to low actual credit losses, but implementation seems relatively straightforward and uncontested.
- Servicing: consumer benefits from more efficient servicing are potentially very large, due to the European banking industry's fragmentation. However, implicit national barriers, such as language,

[61] The following bullet points lean on the unpublished discussion paper of Dübel (2003) that referred to the empirical results of the MOW study. The author was member of the MOW-EMF study team.

culture and private law systems are large, too, and European initiatives, notably in the area of consumer protection, face high implementation hurdles.

- Origination/distribution: consumers would benefit greatly from improved distribution. Consolidation and higher Internet use have accelerated change recently. Practices are idiosyncratic, however, and implementation hurdles for European policies are high.

The basic alternative proposed so far to the comprehensive regulatory approach is direct intervention at the EU level in the form of public guarantees along the lines of the US government-sponsored system consisting of Fannie Mae, Freddie Mac and the Federal Home Loan banks. It is rests on the assumption that standardised capital market institutions can force primary market standardisation, including most of the contested areas of consumer protection. Interestingly, the proposal came from a group of banks seeking European scale in the capital market rather than consumer groups.

When assessing the relative merits of regulatory and direct intervention, one should note that many 'market' failures addressed by public interventions were in fact policy failures, in particular, a lack of regulatory reform.

- Public retail lending in Germany is widely marketed as serving the low-income mortgage market. However, the country remains characterised by regulatory loan-to-value constraints and interest rate controls; moreover, a history of subsidisation of public lenders renders a private mortgage credit supply for low-income households almost impossible.
- Similarly, the French public-private partnership insurance scheme FGAS is widely held to operate reasonably in attracting marginal mortgagors to the market. However, little has been done in France in the past 30 years to address the costly legal process around constituting and enforcing mortgages as well as high credit cost levels through regulatory induced fragmentation. As a result, low-income mortgagors in France are de-facto forced to turn to (public-private) insurance rather than simply pledging their property as collateral.

Similar observations can be made in many interventionist mortgage markets in Europe, for example Netherlands or Sweden. In the team's judgement, apart from the need to contain the actual and contingent costs of a European institutional solution, it should be considered as a last resort after the options for regulatory reform are exhausted. If implemented, it should be focussed on dealing with a single problem – for instance, creating a market in products not universally supplied, such as prepayable fixed-rate mortgages. Any public institution should be sunsetted to avoid an on-the-run agency.[62]

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[62] A good example of the latter is KfW, the German development bank that is using a charter loophole to develop EU wide securitisation programme, whose primary logic is regulatory arbitrage.

In the context of this strategy debate, have the FG recommendations brought progress? The answer seems to be broadly: yes. However, as our discussion has shown, the FGRs are, as they stand not sufficient for generating a consistent regulatory reform programme:

- Given the selection of members and past focus of the European policy debate on the transposition of the CCD to mortgage lending, the strong focus of FG on consumer protection issues is understandable. It seems broadly justified, given the failure of the internal market and the potential and actual barriers to entry erected by idiosyncratic national rules. Another justification would be generic, the need to foster product innovation, which is slow and lagging in many European jurisdictions (see above). On the other hand, only an excellently formulated compromise between market completeness and protection of vulnerable consumers would be acceptable to a majority of stakeholders, and avoid the US trap of regulatory conflict between the subsidiary and federal levels. The CCD in that regard appears to be broadly on the right track, proposing maximum harmonisation and in the 2004 version revoking counselling duties and defusing the prepayment issue. More discussion will be needed, especially with regard to counselling duties and unilateral adjustment of contract conditions. Agreement on the CCD, or an analogous Mortgage Credit Directive, after decades of debate is also important to quell calls for a US-style harmonisation by creation of central agencies that indirectly set consumer protection standards. In the mid-term, however, there is a strong case to consider a risk-based approach for consumer protection as sketched above rather than continuing the current modular and selective law-making tradition which carries the risk of creating new barriers to competition or neglecting new risks to vulnerable consumers arising quickly.
- The impact of financial regulation policy in the mortgage sector, in contrast, seems grossly underrated by both the FG and past and current EU initiatives. Capital markets are a minor exception. The FG recommendations in that regard appear conducive to reach the desired goal, greater accuracy of registers, transferability and pooling of assets, but do not form a viable proposal since regulators and fiscal authorities were not present and are incomplete, leaving out for example the covered bond market. More specific and viable proposals will be needed to mute the calls for public European agencies making the capital market in mortgages (European Fannie Mae proposal). The main problem, however, is continued subsidiarity and inconsistency of financial regulation in the primary mortgage market. Financial regulation in practice decides about whether submarkets of mortgage finance exist or not, or whether classes of suppliers prevail or not. Examples are idiosyncratic supply solutions – for example pre-savings obligation (*Bausparen)* vs. mortgage insurance for high-LTV lending – and regulatory constraints, including the plethora of loan-to-value constraints and limitations in Europe, or differing appraisal

rules. The absence of regulatory advantages for the diversification benefits of a European cross-border mortgage portfolio adds to this. It is hard to see how fair cross-border competition under such circumstances can emerge, and the general thrust towards creating a uniform European regulatory structure, which is the corollary to the maximum harmonisation approach proposed in the CCD reform, or perhaps a European regulator, seems to be confirmed.

- In the same vein, the FG seems to the give insufficient regard to competition policies that have in the past proven effective in removing cross-border barriers and improving domestic efficiency. The German *Landesbanken* case, French deposit subsidies and Italian anti-merger policies are just the beginning. In that regard, it would be important to abandon the case-by-case approach and move towards interpreting the EU Treaty more proactively for the financial sector.
- A major gap for mortgage market development is also the absence of even the nucleus of a European housing sector policy. There is no formal EU jurisdiction when addressing housing sector subsidies and regulations. This leads to the paradoxical situation where the convergence of standards defines the central relative price of the mortgage market (the interest rate), but not of the housing market (the rent). Rent controls and rent subsidies are still pervasive in many European jurisdictions and distort the potential for the mortgage market. In Germany, for example, practically the entirety of the market potential identified by a recent MOW study depends on the progress of rent subsidy reform, which is painfully slow, not least because the average voter is a rental tenant.[63] By contrast, the Spanish legacy rent controls could lead to excessive growth in the mortgage market, which may come at the expense of stability since it reaches into groups that, based on their risk-based interest rate, should probably remain rental tenants in an undistorted market. Clearly, such continued regulatory idiosyncrasy as well as the accompanying subsidies pre-empt successful cross-border entry – for instance of subprime lenders to markets with strong rent subsidies.
- The FG has generated the most tangible results in the areas of collateral policies, registration and enforcement, where there has been the broadest agreements. Unfortunately, these are all areas where the regulatory ambit is very clearly subsidiary. Do the outcomes of the FG discussions suggest there is now a chance to bridge the chasm between national juridical traditions? Some of the proposals, such as those concerning the Eurohypotec, or the ones that address problems

[63] See Mercer Oliver Wyman (2005).

created by varying national property and consumer registers would suggest so.

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