Mortgage Consumer Protection in Europe
– New Regulations, Ongoing Challenges -

Ministry of Land, Infrastructure and Transport

The 3rd International Forum on Housing Finance

November 12 – 13, 2015
Seoul, Korea

Hans-Joachim Dübel
Finpolconsult, Berlin

Structure of the Presentation

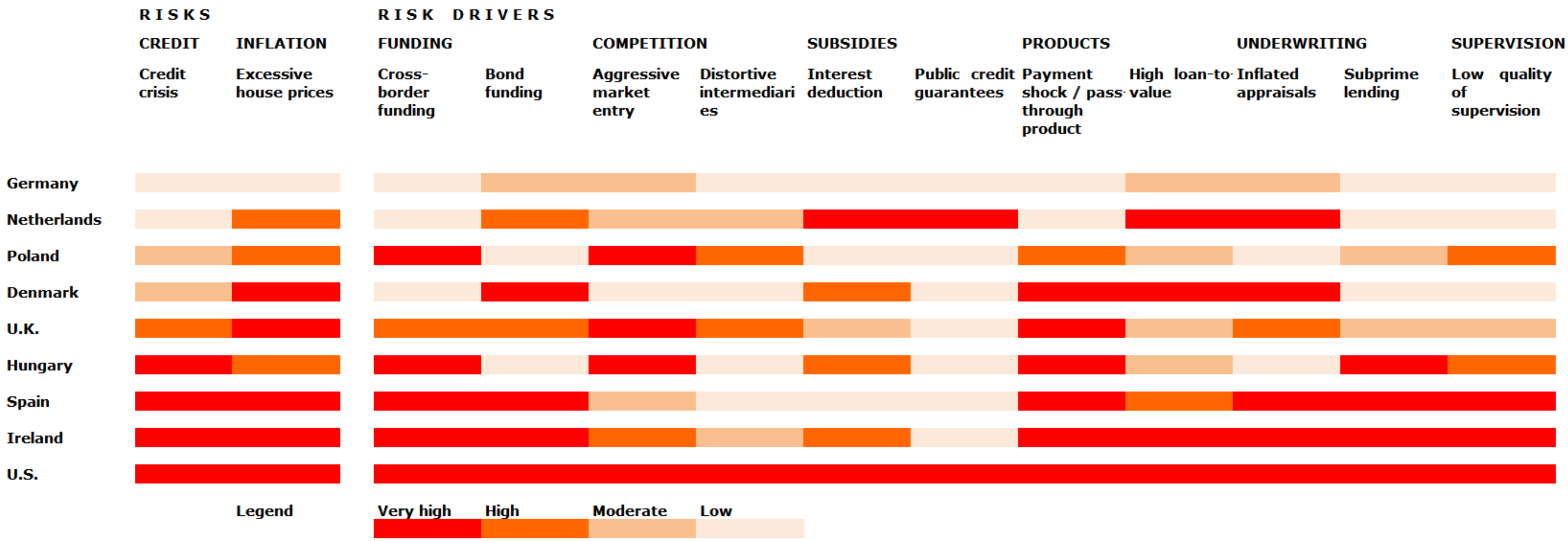
Section 1:
Mortgage Consumer Protection Gaps in Europe that Propelled Mortgage Market Crises

Section 2:
Policy Responses to the Crisis at European and National Levels

Section 3:
Managing Distressed Portfolios

Section 1: Consumer Protection Gaps

Consumer Protection Gaps
Mortgage Credit Crisis Causes Summary



The central crisis cause is a **combination of large cross-border and wholesale funding with aggressive competition and liberalization** of product design and underwriting.

Main **vehicles of funding were bond and interbank funding**, which kept house price inflation going as the deposit base depleted.

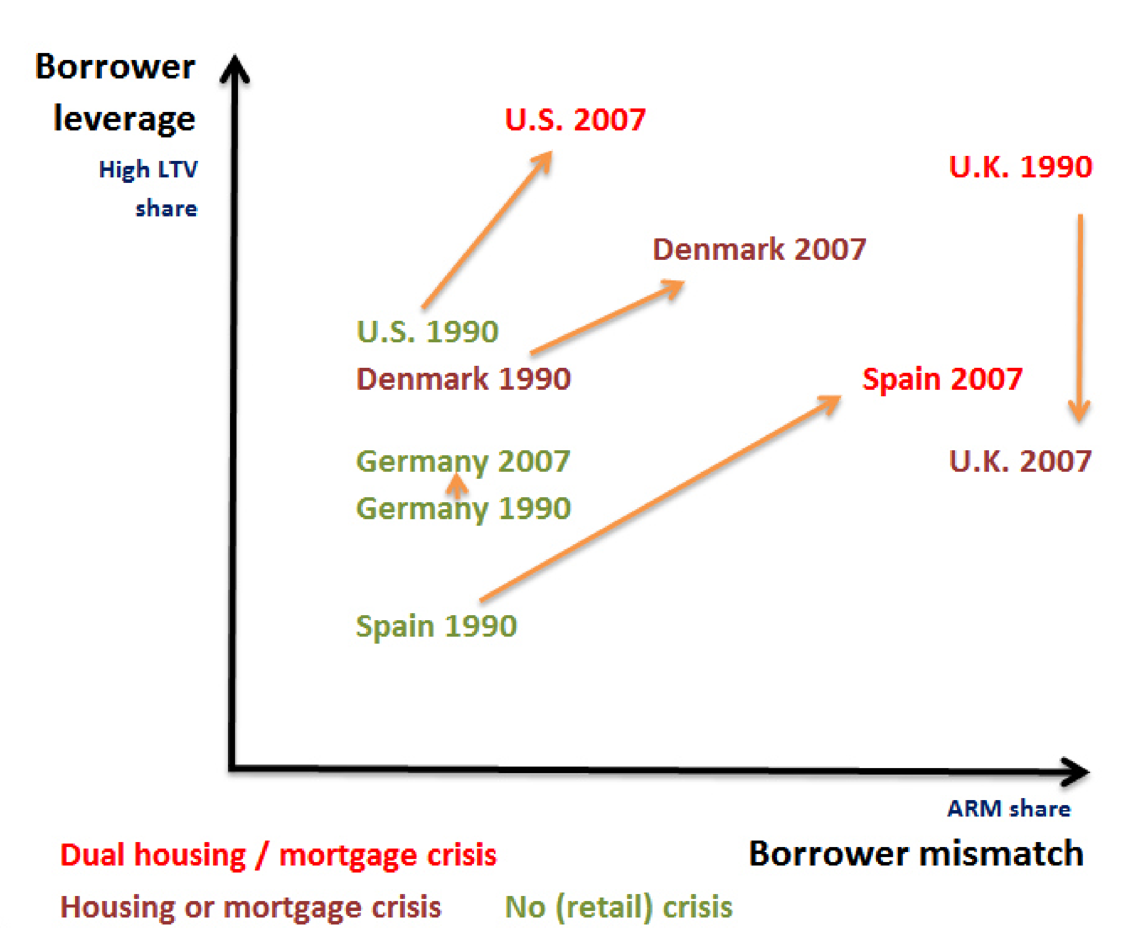
Aggressive competition and product and underwriting liberalization came with the **disappearance of mortgage specialists and entry of universal banks and non-banks in the 1990s.**

Source: Finpolconsult.

Consumer Protection Gaps

Rising Borrower Leverage (Underwriting) and Mismatch (Products) Create Vulnerability

Housing Finance Systems Have Become Riskier, More Vulnerable to Given Liquidity Shock



Vulnerability to a given liquidity shock maximized by:

1. high borrower leverage,
2. high borrower mismatch,
3. inflated house price valuations,
4. small rental sectors .

Liquidity shocks themselves are maximized by

- central bank policies,
- financial innovation,
- autonomous (portfolio) capital flows,
- aggressive cross-border entry.

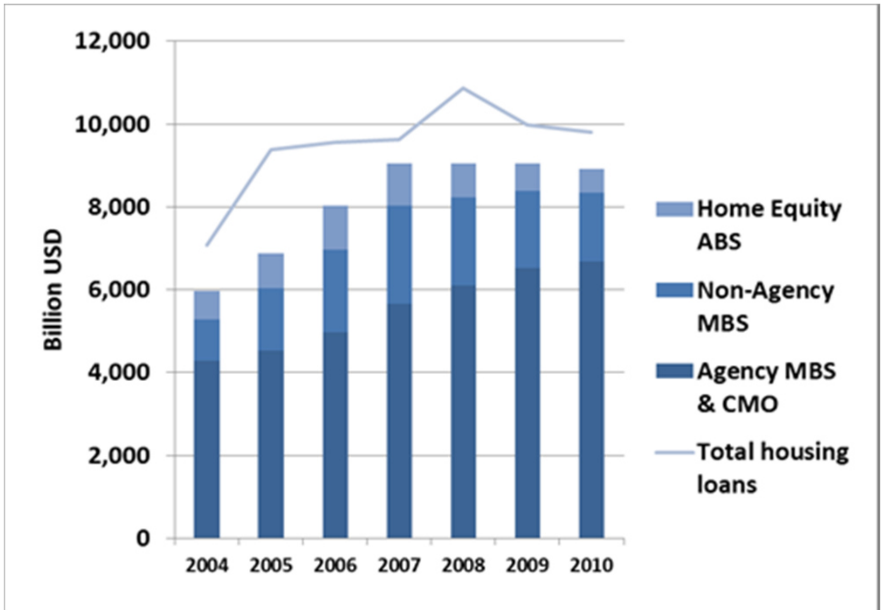
Consumer protection (1-3) and housing policy (4) operate as **buffers against liquidity shocks**.

Liberalization has removed buffers.

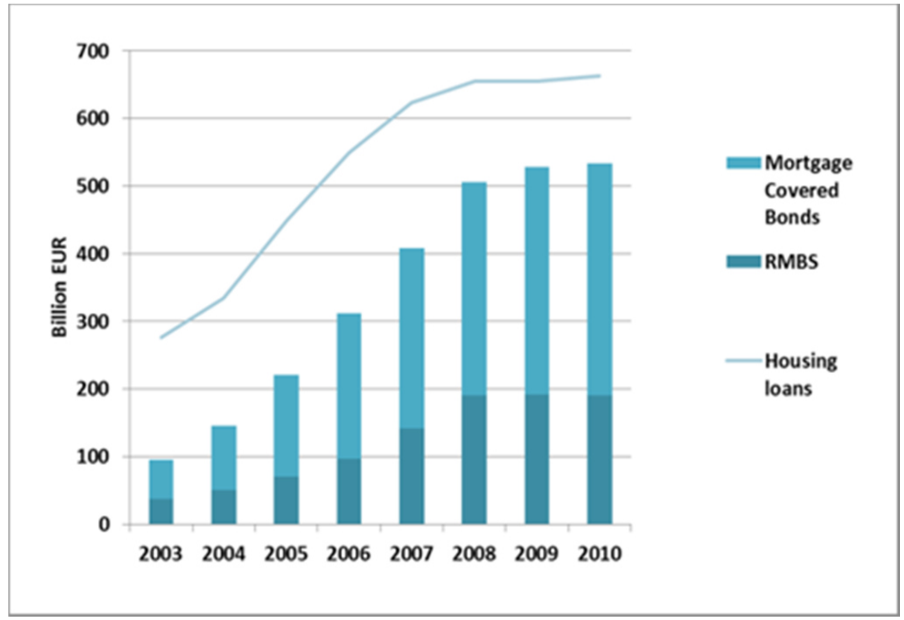
Source: Finpolconsult.

Role of Mortgage-related Securities

United States 2004 – 2010
(capital mkts & insurance-based system)



Spain 2003 – 2010
(bank-based system)



Housing finance **system design = credit intermediary design + funding exit design**

- **Insurance/structured finance**: U.S.: GSE + MBS, Finco's + structured finance, commercial banks + ABS (+ deposits)
- **Banking**: Spain: commercial banks + MBS + covered bonds (+ deposits)

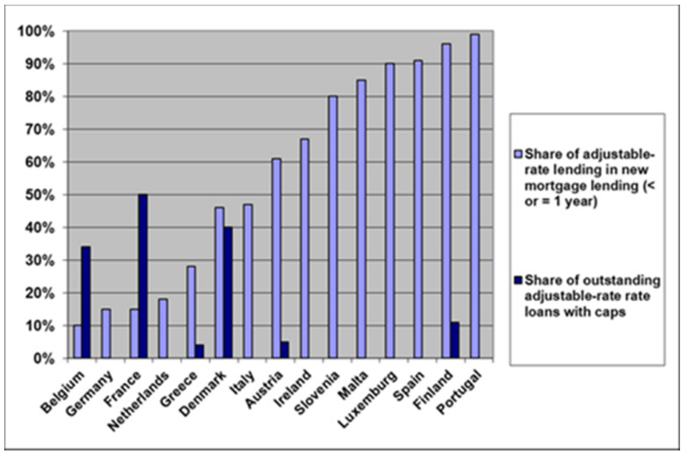
Conclusion: on the macro level, European commercial banks did not materially act differently from U.S. GSE/Finco/Bank mix. **Main carrier of credit boom** were **debt securities**.

Source: Finpolconsult.

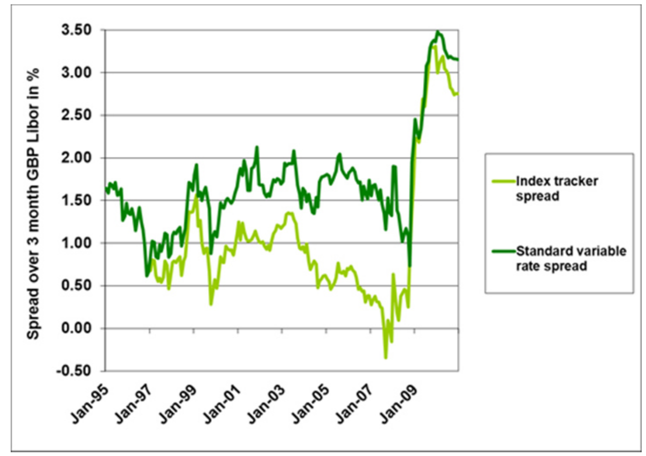
Consumer Protection Gaps

Adjustable Rate & FX Loan Products - Aggressive Pricing, Lack of Risk Protection

Eurozone – Use of ARM Rate Caps and ARM Share



UK Index Tracker vs. Reviewable Rate Product Pricing

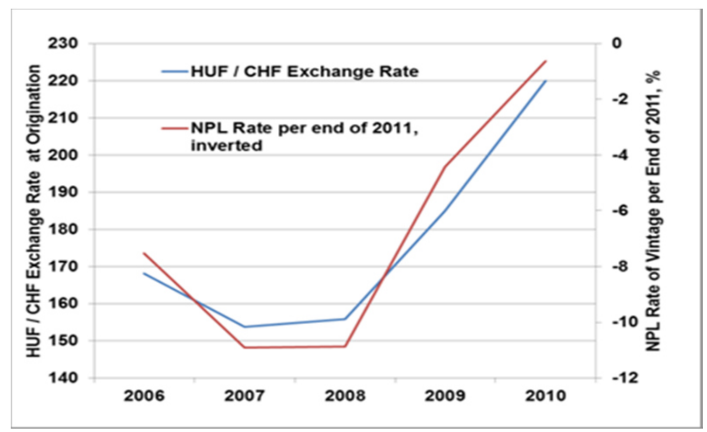


ARM and FX introduced by **commercial banks** as market entry vehicles; specialized / local mortgage lenders had issued fixed-rate; **market share >70%.**

ARM caps are only used **where FRM exists, never mandatory. Interest floors** create **asymmetric risk exposure** (Spain).

FX (CHF) lending **without caps** in Hungary/Poland. Strong correlation of NPLs with CHF exchange rate and house price levels at origination.

Hungarian NPL ratios by loan vintage, Dec 11



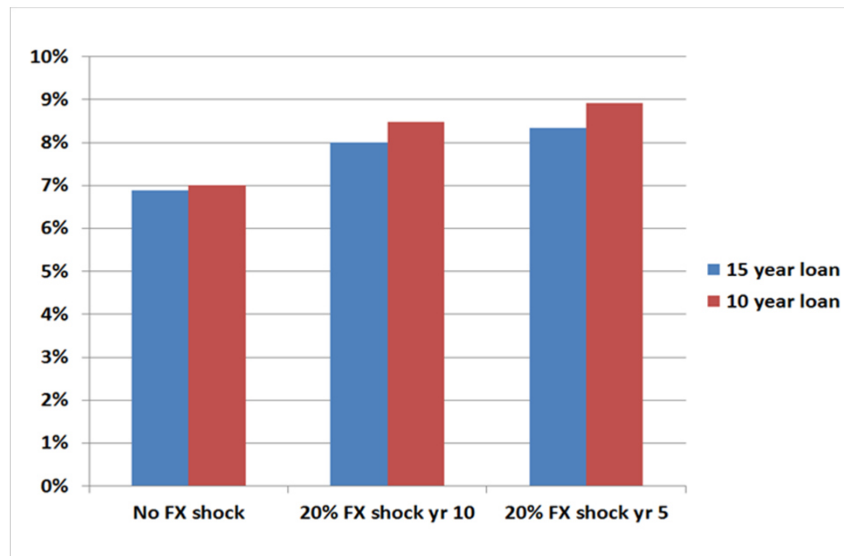
Source: ECB, Bank of England, Hungarian Central Bank, Finpolconsult.

Consumer Protection Gaps

APRC 'Transparency' Standard Creates Bias Against Risk Protection

- Foreign currency lending:
  - Possible **negative amortization stress** after devaluation ignored
- Variable-rate lending:
  - Assumption of **constancy of interest rate** in APRC dubious
- Fixed rate lending:
  - **Contractual maturity assumption** leads to misleadingly picture on cost, prepayment assumptions needed.
  - No consideration of **exercise costs for prepayment** (penalties & legal fees).
- Solutions:
  - **Risk transparency standard**
  - **Classify mortgage products** before applying APRC.
  - Demand **application of vanilla interest rate or FX swap or cap** for ARM/FX to arrive at risk-adjusted pricing.

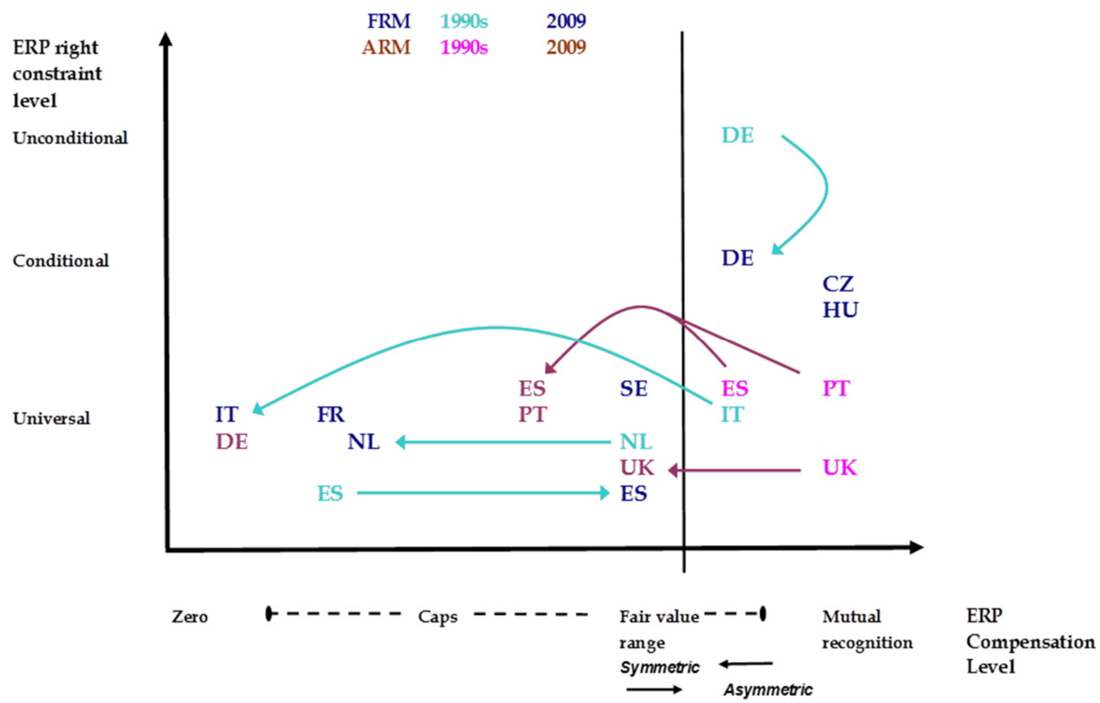
APRC before and after FX devaluation stress



Source: Finpolconsult

Consumer Protection Gaps

Inconsistent Prepayment Regulations Discourage Fixed-Rate Lending



Note: falling interest rate scenario

Issues

- Pressure to reduce or eliminate indemnities entirely creates **prepayment option pricing costs**, ca 30-100 bp
- Most European markets are incomplete, i.e. **no clean separation of callable and non-callable fixed rate** mortgages.
- **Fixed-rate lending market today limited to the 'core'**, France, Benelux, Germany; Denmark reviving.

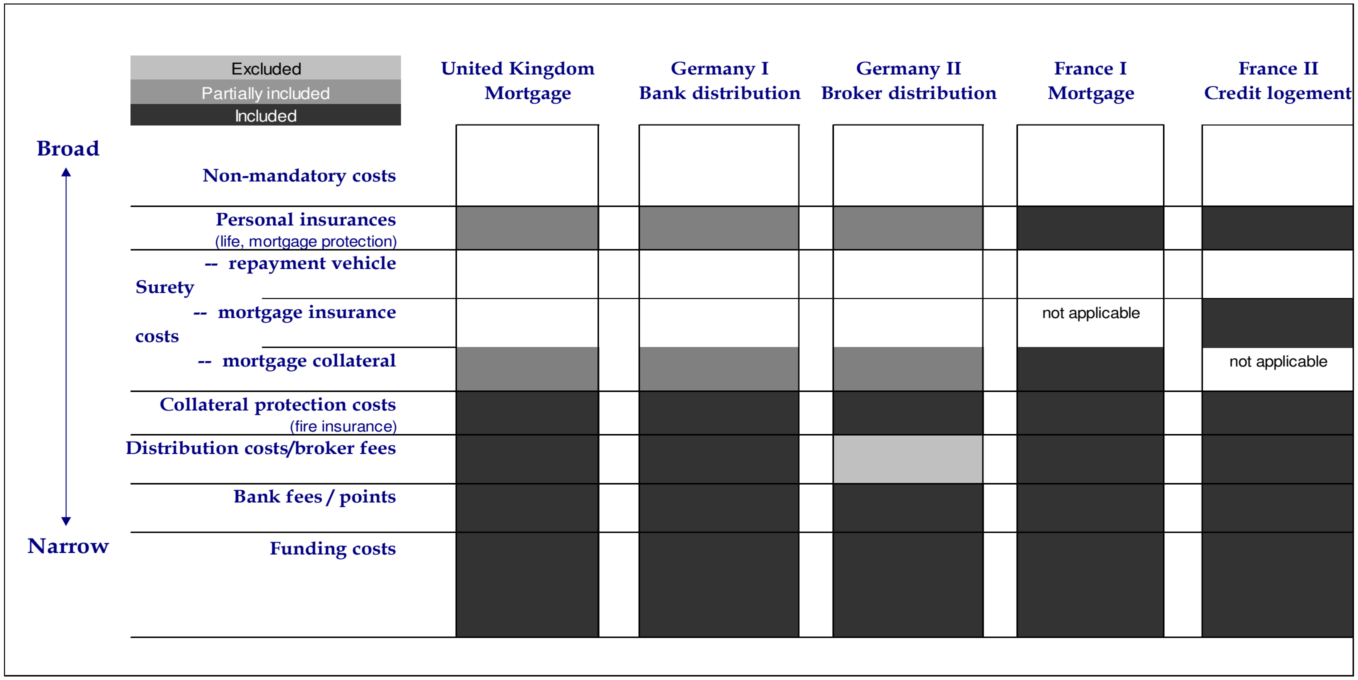
Solutions

- Product separation. **Standardization of yield maintenance indemnities**. Symmetry?

Source: Finpolconsult

Consumer Protection Gaps

Even Non-risk-adjusted APRC Permits Hidden Fees and Margins



Main issues:

- **Sureties:** credit insurance vs. mortgage,
- **Tied products and cross-selling**, e.g. life insurance as amortization vehicle, may lead to risk layering,
- Payment shock products with **low initial payments ideal to hide extra fees** (e.g. FX products).

Solutions:

- Internalization of external costs ('broad' APRC), mandatory joint APRC for bundled products.

Consumer Protection Gaps
Risk Layering on the Basis of Payment Shock Products

- Risk layering

  e.g. Hungary FX and reviewable rate with banks rolling over CDS cost = dual shock, estimated 25% of HU FX loans were interest-only, repayment vehicle performance issues.

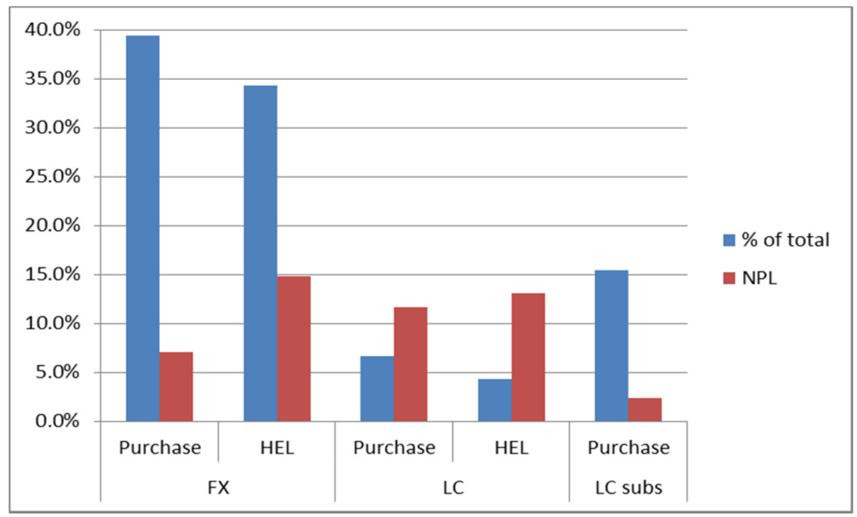
- Generic high-risk

  e.g. home equity loans for consumption purposes (HU close to 40% of outstanding)

Subsidies significantly reduce default rates

- however, potentially extreme fiscal cost (HU Orban I vintages).

Hungary product type and NPL performance, Dec 11

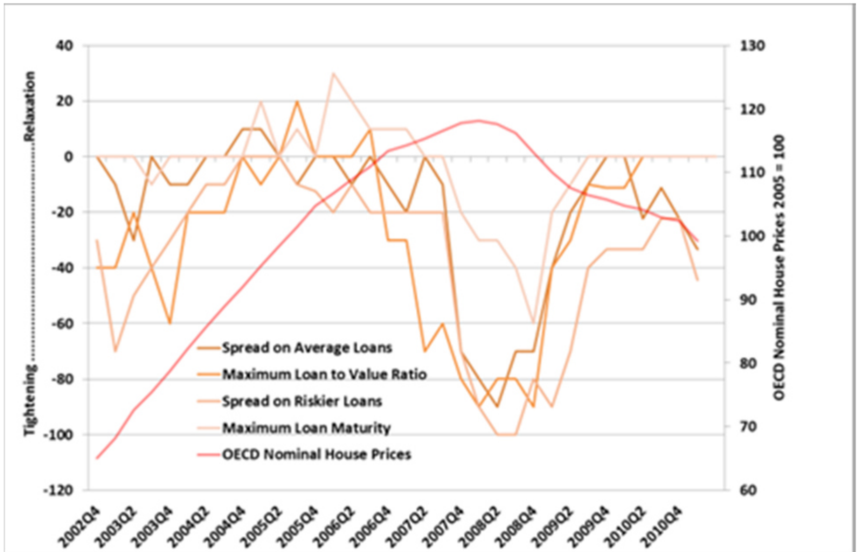


Source: MNB, Finpolconsult. Note: NPL = sum of ‘bad’ + ‘doubtful’ categories.

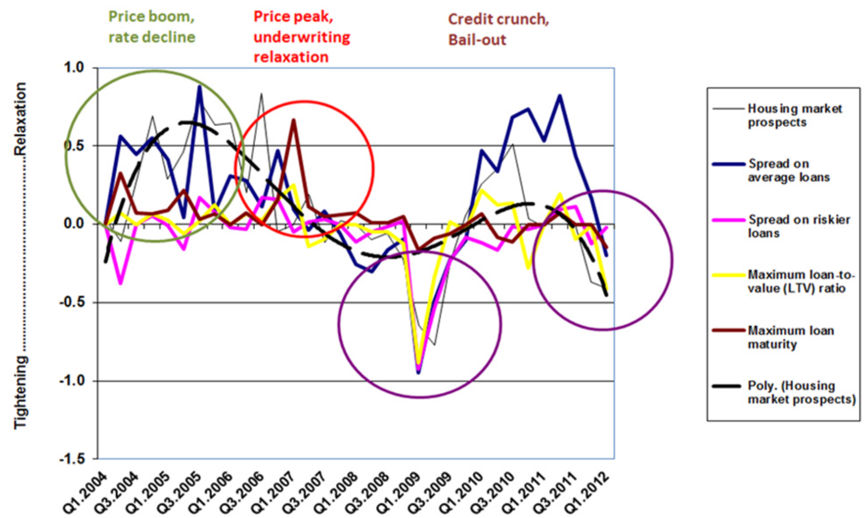
Consumer Protection Gaps

Underwriting Standards are Relaxed Procyclically, Creating Toxic Vintages

Spain, 2002 - 2010



Poland, 2004 - 2012



As house prices increase:

- **Cyclical increase in leverage via** loan-to-value ratios (as opposed to structural)
- **Extension** of **loan maturities** and **negative amortization** features
- Higher frequency of **interest-only periods and initial teaser rates**
- **Lower spreads** for both prime and non-prime lending
- **Low-documentation** lending

Solutions:

- **Lean against the bubble,** or **lean against misleading house price valuation**?

Source: Bank of Spain, National Bank of Poland, Finpolconsult.

Consumer Protection Gaps

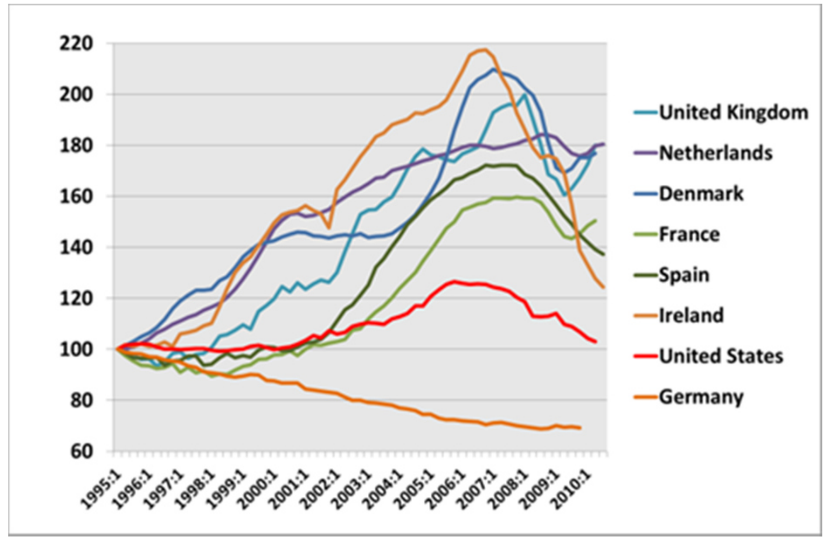
Inadequate House Price Valuation Renders Responsible Lending Rules Unenforceable

Discounted cash-flow valuation (‘income’) method is **superior** to ‘open market’ valuation in matching long-term values (Koo, Shiller, many others).

- Still either contract prices or ‘**open market values’ are the norm in retail finance.**

- In **commercial mortgage finance, however, DCF** based on long-term rent assumptions **is the norm.**

Europe vs. U.S. House Price to Income Ratios, 2005 = 100



Why are consumers treated systematically differently?

Regulators cannot agree on standard

Impact of open market valuation **on responsible lending rules**

- Lenders keep lending into inflated markets, create **further pressure to relax standards** and layer risks.
- **Reference to ‘market prices’ removes liability** for lenders.
- **Denial of credit rules unenforceable** if collateral value is assumed to remain permanently high.

Source: ECRI, Finpolconsult.

Section 2: Policy Responses at European and National Levels

Policy Responses
Pre-Crisis Consumer Protection Regulation Examples

National level

- **France:** Loi Scrivener 1970s, **prepayment penalty caps**
- **UK**: Code of Conduct 1996, addresses first **subprime lending** wave (1980s)
- **CEE** regulations 2002 bis**, trying to lean against FX** lending

European level

- Consumer Credit Directive 1987, **not mandatory for mortgage lending**
- European Single Information Sheet 2006, **no 'risk transparency'**

Northern and Central Europe: focus on pre-contractual **information, self-regulation**

Southern and Eastern Europe: focus on **product regulations**, France on consumer insolvency

EU regulation primarily tried to enforce the **Single Market** (competition)

Policy Responses

Post Crisis - EU Mortgage Credit Directive with Severe Gaps

Issue	Directive	Gaps
Pre-contractual information / credit intermediaries	Standard advertisement info & ESIS. Intermediary authorization, registration, supervision, professional requirements.	Specific cooling-off period. Excessive focus on intermediaries.
APRC	Broad definition mandatory Illustrate possible risks with historic rates	Both narrow and broad (cost of credit) APRC for national / international comparison; combined product APRC; realistic maturity and adjustable-rate assumptions; realistic stress-testing; swaps.
Creditworthiness assessment	Appropriate processes, data and borrower information access. No bricks & mortar underwriting. Duty to deny excessive credit.	Mandatory stress-testing, based on the specific product, amortization and loan-to-value offered.
Governance/advice	Appropriate remuneration structure. 'Adequate explanations'.	Safeguards for intermediary independence (e.g. insurance). Legal conditions for advice.
House price valuation	Not in Directive.	House price valuation standard (discounted cash flow). Duty to deny credit unenforceable.
Loan to value rules	Not in Directive; CRD mortgage definition 100%.	100% excessive. High risk products with lower LTV. Move to address current loan-to-value.
Payment to income rules	Not in Directive	High risk products with lower PTI.

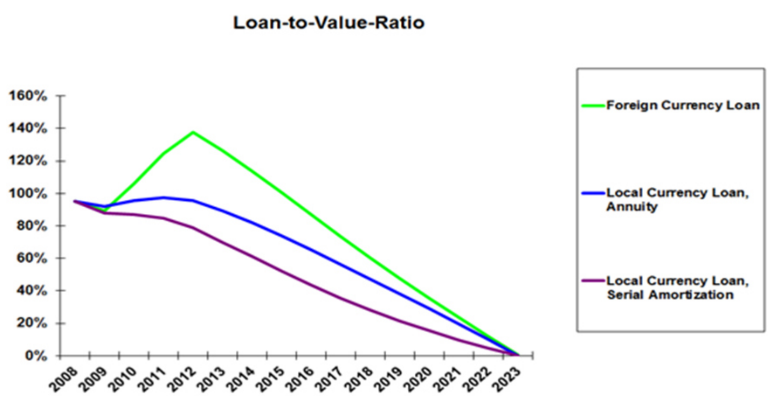
Policy Responses

Post Crisis - EU Mortgage Credit Directive With Severe Gaps

Issue	Directive	Gaps
Amortization rules	Not in Directive.	High risk products to amortize faster.
Products, general	Suitability in conjunction with credit assessment, criteria delegated to KOM.	Standardize products, create uniform set of regulations calibrated relative to risk content.
Tying	Some untying (insurance provider) No 'unfavorable' tying	Risky endowment mortgages remain permitted
Early repayment (FRM)	Early repayment right subject to conditions. Member State discretion on indemnities.	Universal early repayment right. Standardization of indemnities (non-callable FRM).
Rate adjustment (ARM)	No caps. Historic rate illustration (20 years).	Mandatory caps (but <u>not</u> mandatory indexation, 1988 CCD), including for FX. No retroactive FX legal restructuring.
Foreclosure/Discharge	Pre-foreclosure 'encouraged', arrear fee caps at 'costs', residual debt 'facilitate'	No specifics given
Non-regulated areas / delegations	5 year review of post-contractual stage regulation need. Limited number of delegations.	Interaction process with Member States re more far-reaching rules. Loan assignment. Linked contracts (developer/bank).

Policy Responses
National Loan-to-Value Ratio Regulations for FX Lending

FX LTV (Hungary) vs. LC LTV Profiles



- **Underwriting LTV** limits are the **standard**
  - Regulations **driven by availability of LC credit** (high in Croatia, Serbia), crisis experience (low in Hungary),
  - **For full downside risk protection FX LTV must be very low** –> extreme rationing, HU 50% LTV for EUR loans
  - **EU Directive: 20% devaluation stress** would suggest e.g. FX LTV of 70 and LC LTV of 85,
  - LTV limits are **imposed procyclically, i.e. deepen recession.**

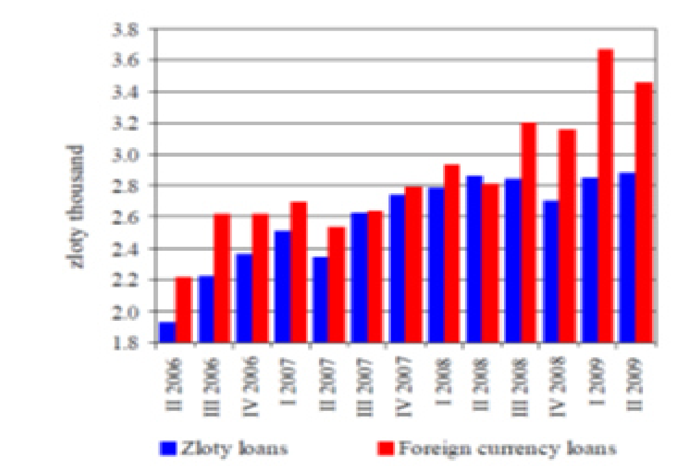
- Alternative = address **current LTV risk**
  - **Faster amortization** for FX loans, e.g. serial instead annuity →invest affordability gain, Poland 25 yrs.
  - **Negative amortization limits** and / or FX caps→insurance premium.

Policy Responses
National Payment-to-Income Ratio Regulations for FX Lending

- **Calibration issues**
  - FX payments are **systematically below PTI limits**
    → back-end default risk remains intact
  - **Radical income stress** (Hungary) pushes households into **high PTI LC lending**
    → front-end default risk
  - HU reacted in 2014 by lowering FX (EUR) PTI ratios to 25%
  - **Cumulation of FX and interest rate stress**?
    - Hungary yes (reviewable rate)
    - Poland no (interbank index)

- **Implementation issues**
  - Poland FX-LC income differential collapsed during 2007 house price boom
  - Latvia implementation highly procyclical

Poland Income Differential PLN and FX Loans



Sources: NBP, REAS

Section 3: Managing Distressed Portfolios

1. Loan modifications and conversions

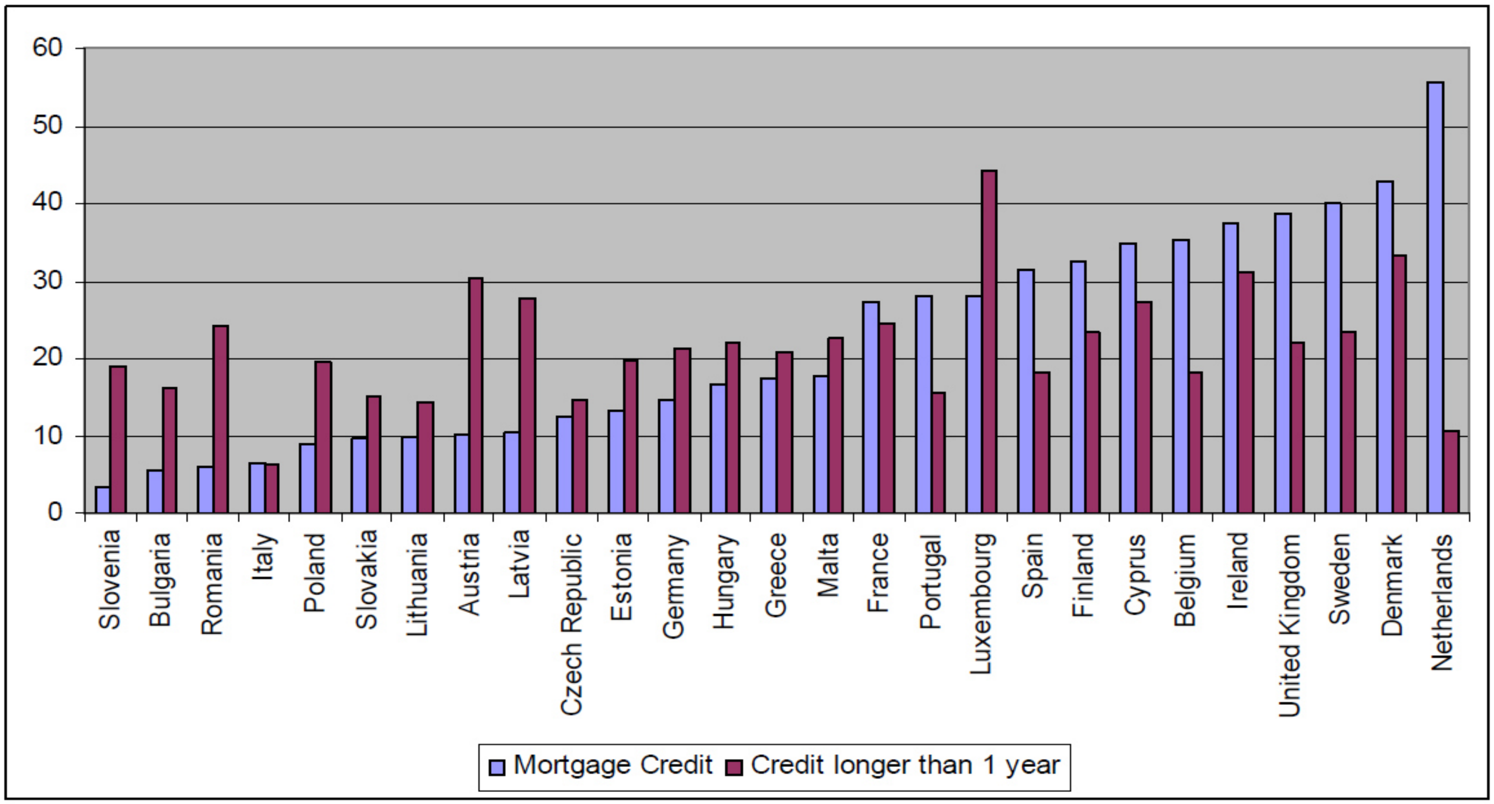
2. Other foreclosure avoidance/pre-foreclosure strategies

3. Reform of consumer insolvency law

Distressed Portfolio Management

Result of Lending Boom – Peak Household Debt Levels 2009

Graph 13: Consumer use of credit (share of households with credit, %)



Source: *Consumers' views on switching service providers*, Eurobarometer, European Commission, January 2009, p. 37 and 52

Source: EU Commission

Distressed Portfolio Management

Non-Performing Loan Levels 2014

Figure 2a. *Euro Area*: Gross Nonperforming Exposure (NPE) Ratios by Sector
(asset-weighted average; in percent of total assets, 2014)

	Total	Corporate	Retail	Total *(in percent of GDP)*
Cyprus	39.4	46.3	29.6	48.0
Ireland	32.2	50.2	21.7	40.9
Greece	25.3	23.2	26.9	25.4
Slovenia	20.2	29.9	11.1	14.6
Italy	17.6	21.0	13.7	12.0
Spain	12.2	18.8	6.8	9.1
Latvia	9.7	7.3	12.1	3.7
Lithuania	8.9	9.7	8.1	3.2
Portugal	7.9	11.1	5.7	7.3
Malta	6.3	8.8	4.7	3.0
Luxembourg	5.0	5.3	3.1	7.0
Slovak Republic	5.0	6.0	4.3	4.4
Austria	4.6	5.0	4.0	2.0
Denmark	4.0	5.5	1.9	1.6
Netherlands	3.7	7.7	1.8	5.5
Belgium	3.4	5.1	2.4	2.3
France	3.2	2.9	3.4	2.7
Estonia	2.5	2.3	2.6	1.4
Finland	1.7	1.8	1.6	0.9

Figure 2b. *Non–Euro Area*: Gross Nonperforming Loan (NPL) Ratios by Sector
(in percent of total loans, 2014)

	Total	Corporate	Retail	Total *(in percent of GDP)*
San Marino	42.3			17.9
Albania	22.8	25.9	15.7	13.6
Serbia	21.5	26.7	10.3	10.5
Montenegro	17.2			10.4
Bulgaria	16.7	19.2	17.7	11.9
Croatia	16.7	30.5	12.0	8.1
Hungary	15.6	13.8	18.9	8.7
Bosnia & Herzegovina	14.0			6.6
Romania	13.9	18.7	7.8	4.3
Macedonia	11.3	15.3	5.9	11.3
Iceland	7.9	7.2	10.1	147.0

Source: IMF

Distressed Portfolio Management
1. Loan Modifications & Conversions

Modification of **interest payments**

- European **portfolios in distress** were **frequently underwritten with index-linked variable rates**. This permitted central banks to keep borrowers afloat through low rates.
- Where rates were **reviewable**, as in Hungary and Serbia and spreads over central bank refinancing rates increased, **retroactive legislation was applied to re-tie them to indices**.
- In Spain, **Euribor contracts were written with interest floors**, leading to excessive interest payments. Invalid clause, however no retroactive legislation to fix. Instead mass **foreclosure**.

Modification of **principal, haircuts**

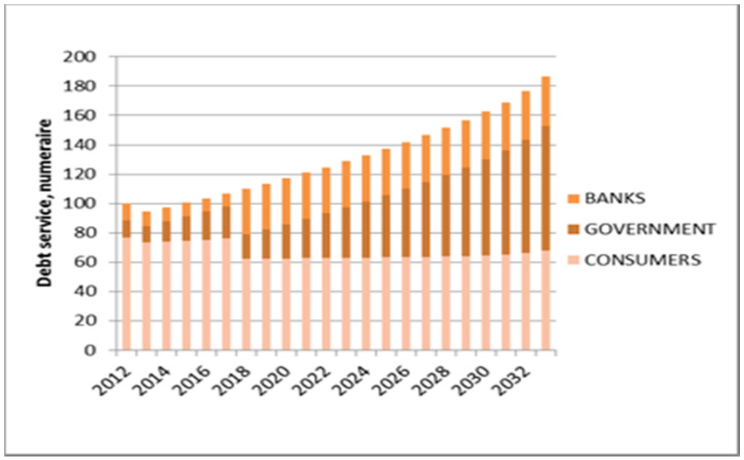
- **Hungary** in 2014 **mandated a conversion** of Swiss Franc loans at a low exchange rate into Forint, imposing losses on banks. Poland, Croatia and Cyprus are about to follow this example.
- Greece: courts mandated **extension of maturities** to 30 years and more (subject to very wide collateral value limits, contentious with 'Quadriga').

Source: Finpolconsult.

Distressed Portfolio Management

FX Loan Modifications and Conversions in Hungary, Initial Phase 2011

Hungary FX legacy portfolio post-restructuring debt service simulation 2011



Source: Finpolconsult computations.

- Initially no retroactive interest rate modification
- Retroactive FX caps modify or convert principal

Option A: **FX loan modification** with the burden being split between lender and government.

2 critical FX levels. Excess FX risk is taken by government.

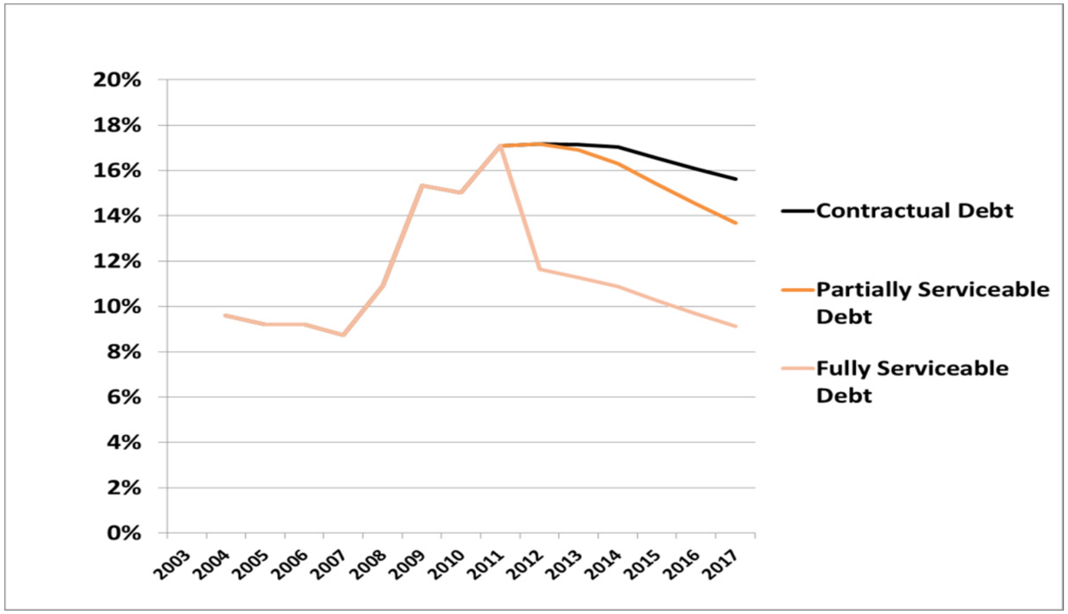
Option B: **FX→LC conversion**

80% conversions were made with cash, i.e. high income /net worth borrowers.

No alternative LC loan product.

Distressed Portfolio Management

Hungary Initial CHF Loan Modifications, Debt Service-to-Income Dislocations

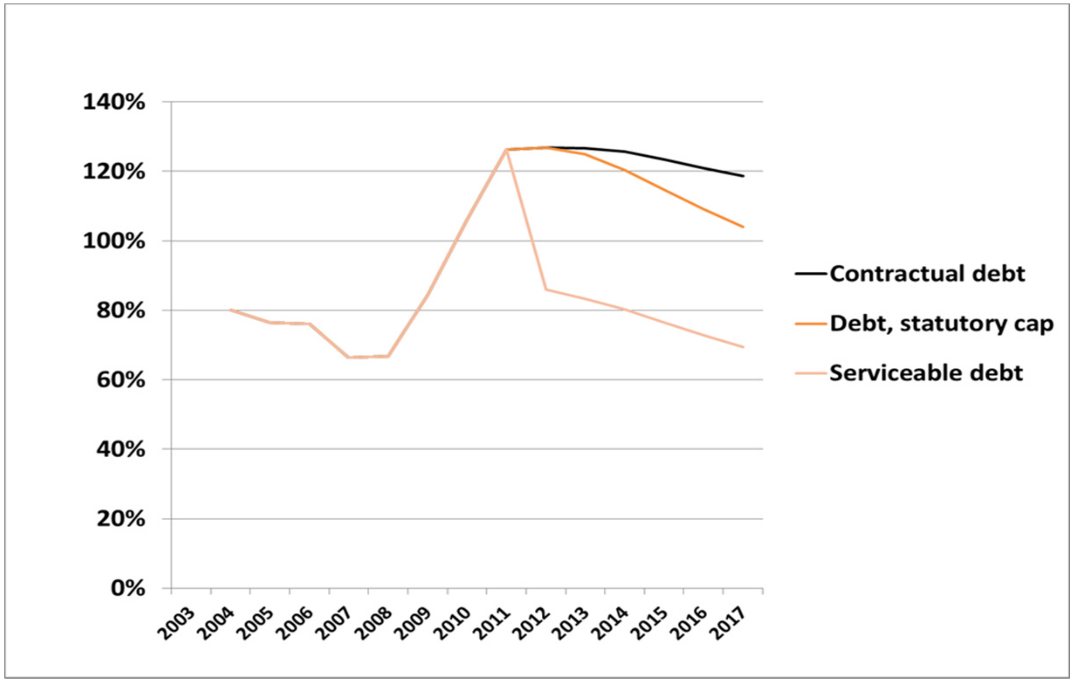


- CHF loan modification in Dec 2011, following shock depreciation from 150 to 250 HUF / CHF
  - Fully serviceable debt (principal & interest) between 0 and 180 HUF / CHF
  - Partially serviceable debt (principal-only for 5 years) between 180 and 270 HUF / CHF.
  - Not serviceable debt above 270 HUF / CHF (cancelled by government)

Distressed Portfolios

Hungary CHF Loan Modification, Loan-to-Value Ratio Dislocations

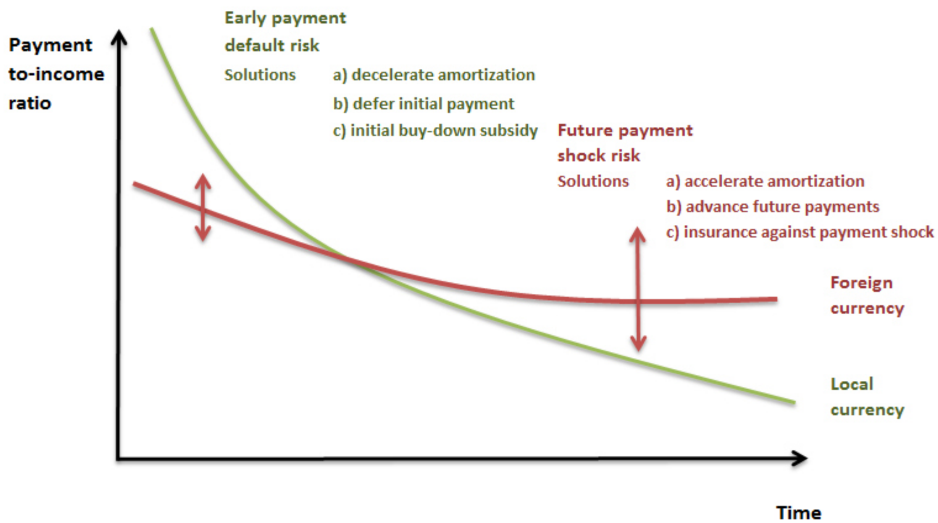
- Many borrowers were ‘under water’.
- Exchange rate cap addresses both underwater risk (LTV) and cash flow risk (DTI)
- Yet, highly untargeted, as different vintages closed at different exchange rates.
- Also, some cash flow risk was related to excessive interest rates (unilaterally reviewable by lender).



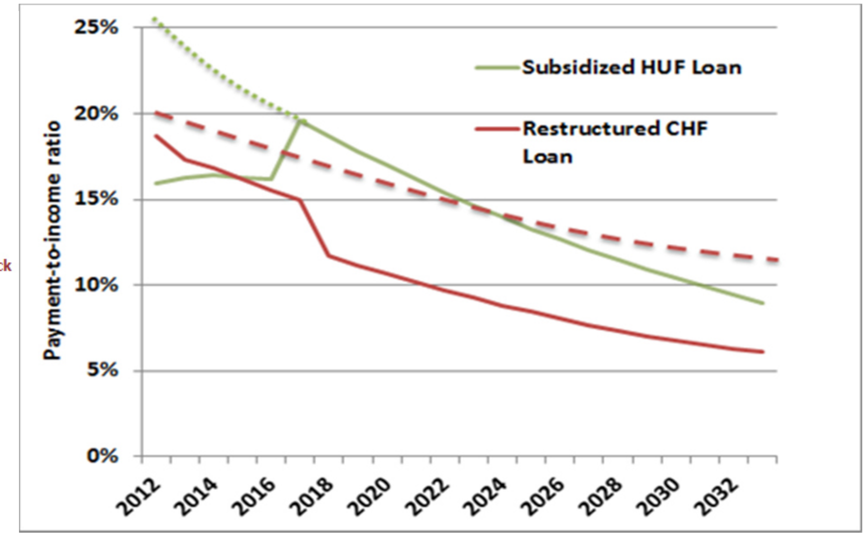
Distressed Portfolio Management

Search for Alternative Local Currency Products, Interim Phase 2012-2013

Tilt effect, strategies to address default risk in LC vs. FX mortgage lending (PTI profile)



Hungary – PTI profile of HUF / CHF loan products post subsidies / restructuring, 2012 proposal



- LC causes **'tilt'effect** of PTI, LTV due to inflation (long-term lending only)
- LC lending at high rates implies **initial burden reduction**..
  - Interest rate buy-down subsidies
- ..or shift of burden to later phases
  - Reduced initial amortization,
  - Lower initial rates.
- **FX** creates automatic shift of burden, but **high payment shock risk.**

Proposals failed due to high subsidy needs for HUF loans.

Hungary already faced high fiscal burden from previous subsidized lending.

Source: FHB, Finpolconsult.

Distressed Portfolio Management

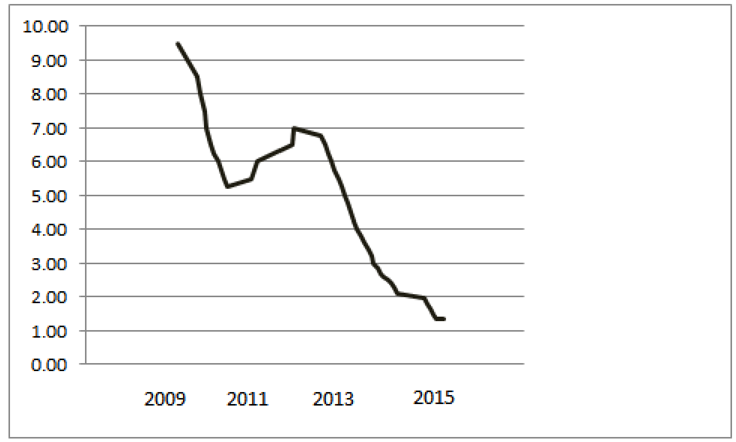
Reindexing 2013 and Final Mandatory Loan Conversion 2014 in Hungary

2013 Supreme Court order: **reviewable CHF loan interest rate were reindexed** to CHF interbank rates.

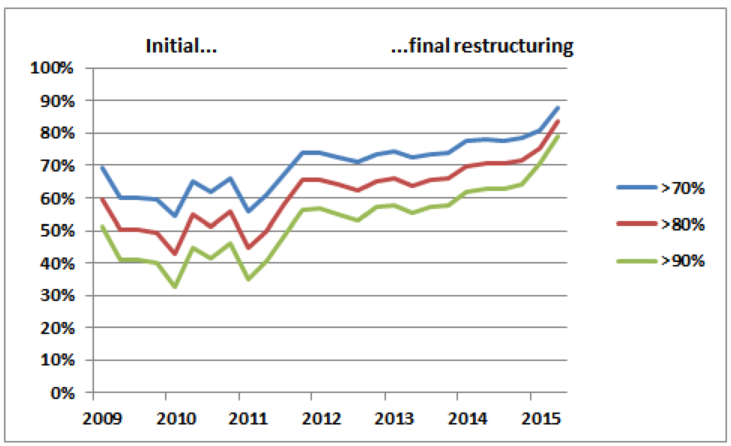
2014 Hungary adopted **mandatory conversion only after local currency interest rates had fallen** steeply (2014).

Banks took losses due to **low FX conversion rates** and restrictions on exchange rate computations.

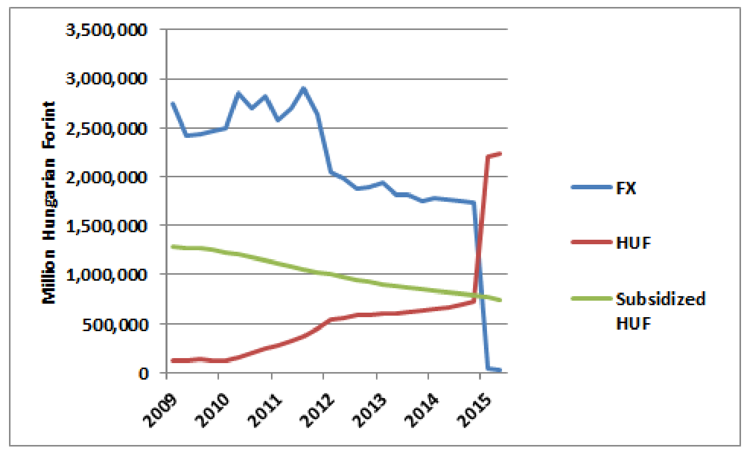
Local Currency Monetary Policy Rate



LTV Distribution of FX Housing & Home Equity Loans



FX vs. Local Currency Housing & Home Equity Loan Outstanding



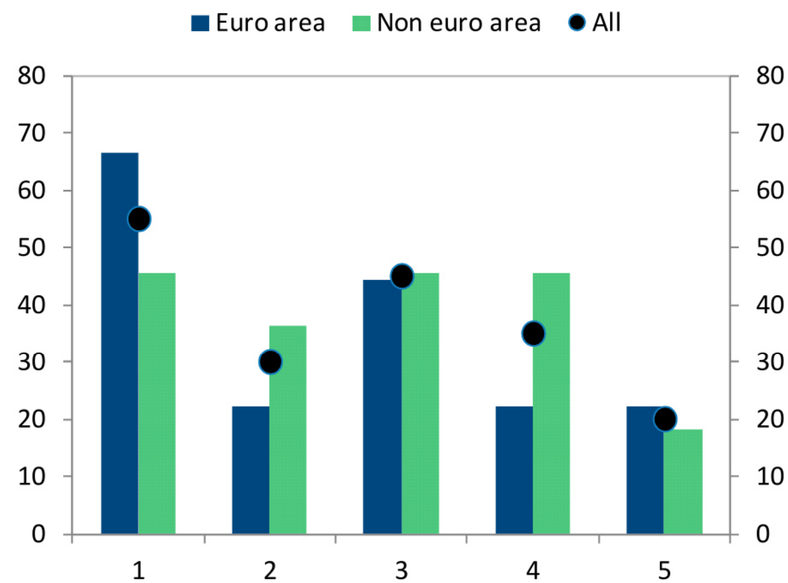
Source: MNB, Finpolconsult.

Distressed Portfolio Management
Conversion of CHF loans into EUR loans in Croatia

- Initial conditions
  - CHF loan portfolio quality below average (NPL19.2%, vs general household NPL ratio of 17.3%.)
- Goals
  - Move fast as further CHF devaluations are possible and other CEE countries moved.
  - CHF loan borrowers in the same position that they would have been in had their loans been in EUR.
- Legal measures
  - CHF loans are converted into EUR, CHF-indexed Kuna loans into EUR-indexed Kuna loans
  - The interest rate on the converted loans will be equal to the interest rate that would have been charged by the lender in respect of a loan denominated in or linked to euros at the time of origination (EUR rates>>CHF rates)
  - 50% of overpayments mandated to be accrued to future installments, not principal. Lender and borrower can agree to apply exceeding 50% to principal.
  - Expenses in the accounts of the creditor will be treated as a tax deductible expense.
- Impact on stakeholders
  - USD 3.4 billion loan volume, expected losses for lenders ca USD 1 billion
  - Lawsuit against Croatian government in International Center for Settlement of Investment Disputes
- Critique
  - Not targeted to defaulting borrowers, not means-tested. NPL situation not critically different.
  - Comprehensive measure is more likely to succeed. Hungarian program ended in adverse selection (affluent borrowers converted).
  - General critique against retroactive legislation (alternative is court action).

Distressed Portfolio Management
A General Picture of Loan Modification Tools in Europe

Figure 11. Use of Restructuring Tools, 2012–14
(percentage of respondents within each group)



(1) interest-only loans
(2) debt or equity swaps
(3) reducing repayments by warehousing a portion of debt
(4) performance-based write-off of a portion of debt
(5) other tools
Source: *IMF survey.*

Source: IMF

2. Other Foreclosure Avoidance and Pre-Foreclosure Techniques

Foreclosure avoidance

- Foreclosure practices have been highly variable: from **de-facto zero in Ireland to mass foreclosures in Spain**
  - Ireland never permitted foreclosures due to historic concerns (British occupation).
  - As in previous crises, e.g. the UK in the early 90s, mass foreclosures were stopped after public protests (Spain, Hungary).
  - Low caseload cases, e.g. Romania, with continued elevated foreclosure activity.
- Foreclosure legislation **tightening in Greece and Cyprus**, lifting blanket moratoria, lowering primary residence collateral limits.

Pre-foreclosure techniques other than loan modification

- Prepayments/arrears counseling
- Short sales (Spain, Ireland, Greece) = immediate discharge
- Rental housing conversion

Source: Finpolconsult.

Distressed Portfolios
Prepayments/Arrears Counseling

Prepayments of expensive loans or loans with abusive clauses

- Southern European legislation traditionally caps prepayment penalties. Problem: most loans in the 'periphery' are cheap (Euribor), there is nowhere to prepay into.
- Spain prepayments of variable rate loans with interest rate floors 2007 bis
  (quasi-mandatory as floors were considered an abusive contract clause pre-empting automatic relief through declining rates)

Arrears counseling/fee management

- Professional arrears counseling: UK 1990s, France, 1989 bis, Ireland 2009 bis
- Legally capped arrears fees (several European jurisdictions, EU Directive)

Distressed Portfolio Management
Limited Short Sales, Rental Conversions in Spain

Inadequate consumer protection/ foreclosure law framework

- 100 year old mortgage execution law. Invalid clauses (collars) do not stay the execution, no direct information to borrowers.
- No consumer insolvency law and no debt discharge rule, i.e. high risk of residual debt.

Foreclosure politics

- Government is owner of regional banks with biggest problems.
- Mass evictions hit mainly migrants.
- Currently eviction moratoria. Conversion of repossessed stock into social rental with same household.

Main management approach

- Debt redemption through short sales, but only if the bank agrees or for very low-income households (2012 law).

Proportion of Foreclosed Mortgages in Europe

Table 7
Proportion of foreclosed mortgages

	Foreclosed Mortgages	Outstanding Mortgages	Foreclosed/ Outstanding	Foreclosures/ Defaulted Mortgages
Denmark (2010)	957	1,500,000	0.1%	12%
Ireland (2010)	368	800,000	0.05%	1%
UK (2010)	36,300	11,725,000	0.3%	15%
Spain (2010)	47,809	6,810,470	0.7%	29%
Spain (2012)	74,184	7,056,713	1.1%	30%
US (2010)	2,870,000	48,684,211	5.9%	79%

Source: BBVA Research based on ECB and national sources

Critique

- Unfair foreclosure law, European Supreme Court stopped.
- No direct attack on overindebtedness, reliance on payment modifications.
- High share of portfolio under water.
- NPL rates remain at historical high at 5.8% (Jun 15), despite ECB bailout.

Source: BBVA.

Ireland – More Comprehensive Short Sales and Rental Conversions

Strong protections against foreclosures of main residence and esp. evictions

The emphasis is keeping people in the family home. If a person seeking bankruptcy shares ownership of the family home with a spouse or civil partner, the official assignee has a number of options:

- If the house is in positive equity, the official assignee can apply to the court to sell the house.

  The spouse or civil partner will be given first priority in terms of buying out the positive equity and keeping ownership of the house.

- If the house is in negative equity, there is usually no incentive to sell.

  If mortgage repayments are similar to what the rent payments would be under a reasonable standard of living, it is envisaged a deal will be struck with the bankto keep the family in the home.

Distressed Portfolio Management

3. Reform of Consumer Insolvency Law

IMF 2014 survey

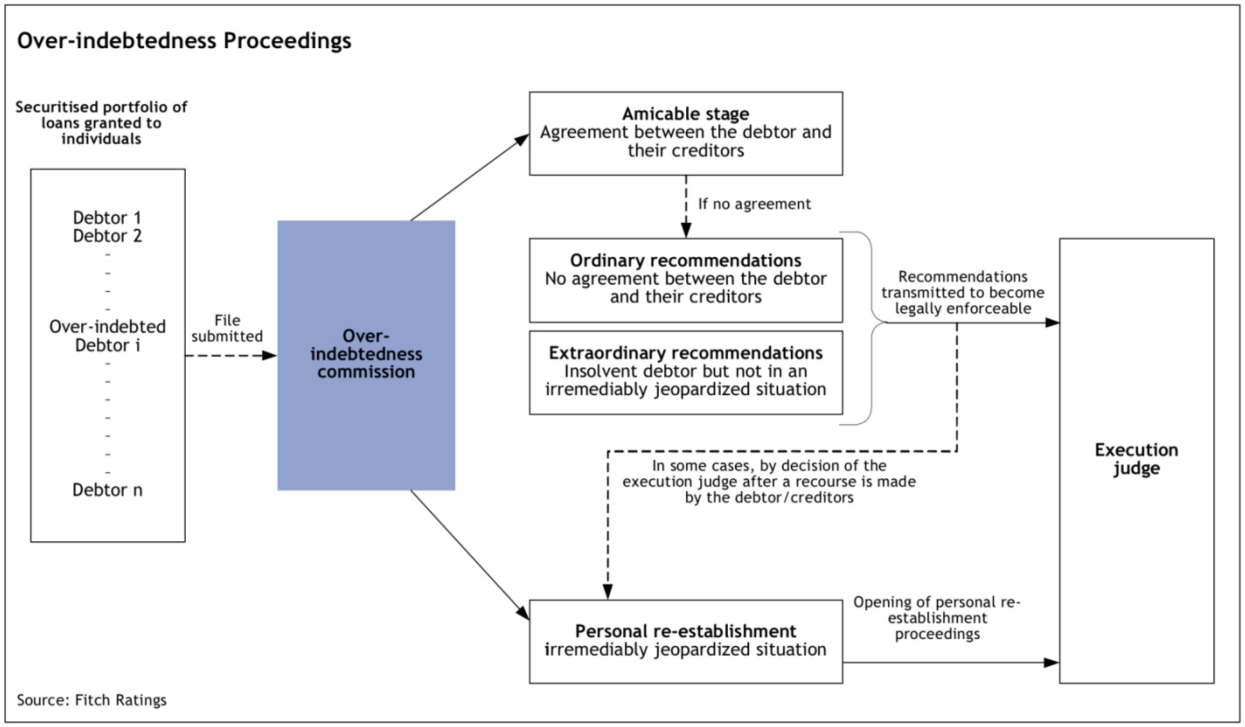
- Personal insolvency regimes are **absent in over one-third of** surveyed **countries.**
- About **one-third do not have an out-of-court settlement mechanism or mediation** for personal insolvency.

Main trends regarding the **default penalty**

- **Absence of** consumer **insolvency rules** and **high default penalty** (residual debt after foreclosure) tends to **prompt political constraints on foreclosures** (Ireland, Spain).
- This creates **pressure to limit the time to discharge**. In Ireland the 'bankruptcy period' was cut from 12 to 3 years.
- The **typical discharge period** elsewhere in Europe is now between 3 (Britain) and 6 (Germany) years.
- Despite the reductions, there are so far **no attempts to introduce no recourse legislation** (US experiences).
- Level of recourse / **default penalties and default rates** do **not** seem to be **systematically correlated** in Europe.

Distressed Portfolio Management

French Mediation & Discharge Approach – Neiertz Law (1989)



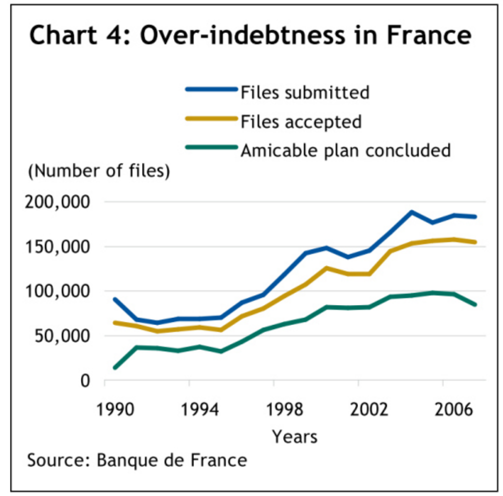
1. **Negotiated ('amicable') solution** to restructure debt, with **mediation from public Overindebtedness Commission**, or
2. **Referral to execution judge** declaring civil legal reorganization and personal reestablishment (discharge).

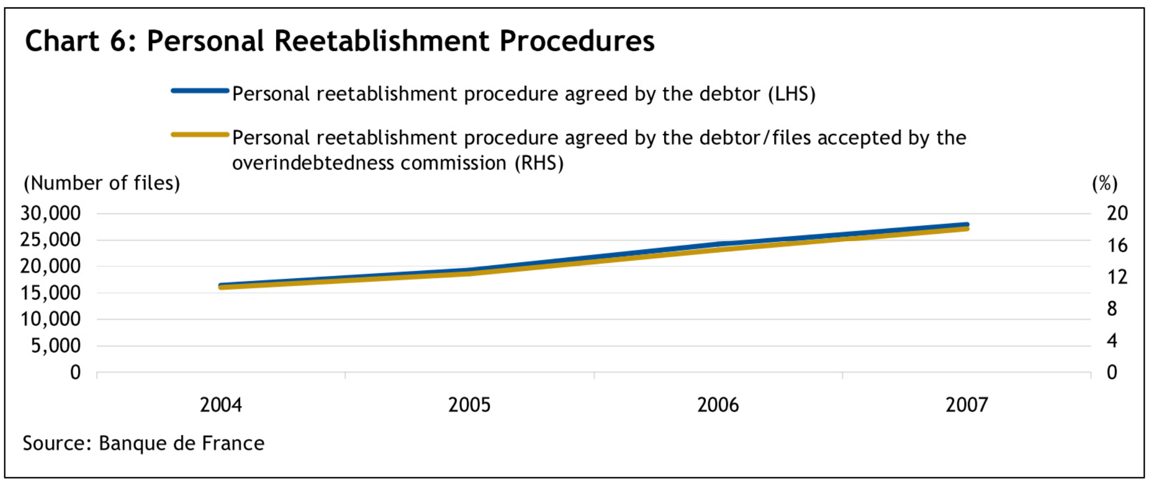
Historic motivation for the law: cumbersome public foreclosure and bankruptcy procedures.

Distressed Portfolio Management

French Mediation Approach – Processes and Outcomes

1. Designated representative assess the economic and social situation of the debtor. **4 month observation period**, all the debtor's creditors will be invited to submit their claims.
2. A liquidator will then have 12 months to sell any assets, either under an amicable agreement or forced sale; they will then split the proceeds between the creditors by priority.
3. 2 year discharge period before personal re-establishment.





Ca 60% of cases end with amicable solutions.

Increase in debt discharge cases.

Limited mortgage caseload so far, but in principle fully applicable to a mortgage credit crisis.

Conclusion

Consumer Protection Regulation – Not Rocket Science, But Hard to Enforce

Consumer information

- Full **options- and risk-adjusted price** quotes
- **Risk classification of products**
- **Independent advisers** need stimulation (free rider problem)

Material consumer protection

- **Minimize leverage**, ‘qualified residential mortgage’
- **Minimize mismatch**, require caps and faster amortization for payment shock products
- House price valuation using commercial valuation techniques, **long-term sustainable value**

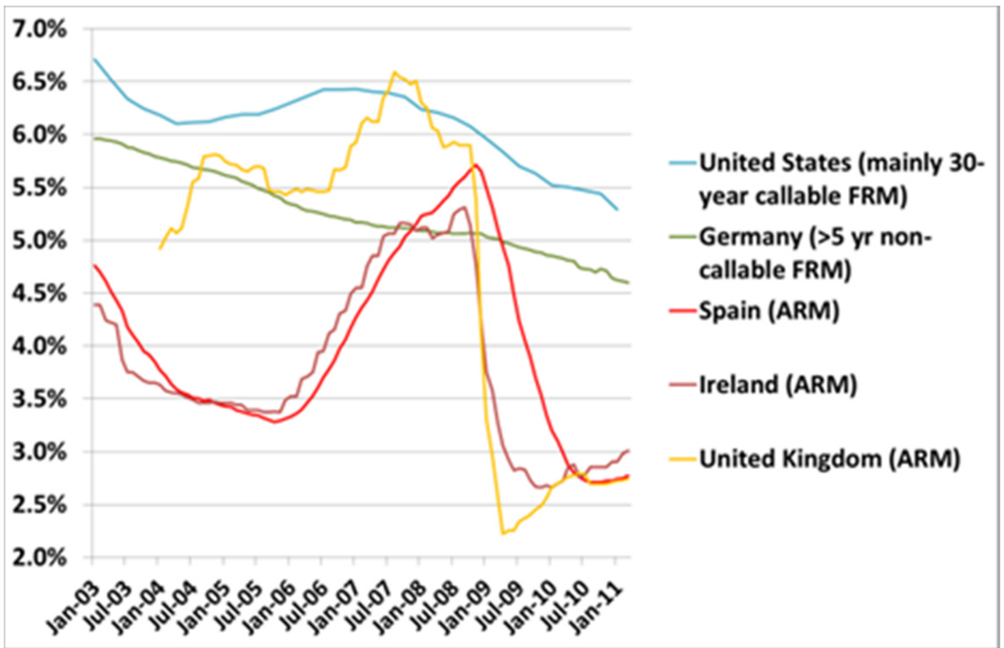
Distressed portfolio management

- **Excessive debt levels** ought to be **addressed directly**, not merely through payment modification.
- **Toxic products imply toxic debt restructuring** approaches (targeting/’proportionality’ has limits).
- Consumer insolvency regime should strike a **compromise between permitting a fresh start and keeping a default penalty** intact.

Consumer Protection Gaps
Variable Rate Loan Products Permit Automatic Bailout (Index Trackers)

Policy Interventions Bail out ARM Borrowers

Key Mortgage Portfolio Interest Rates 2003-2011



Source: ECB, Bank of England, Finpolconsult.

Consumer Protection Gaps

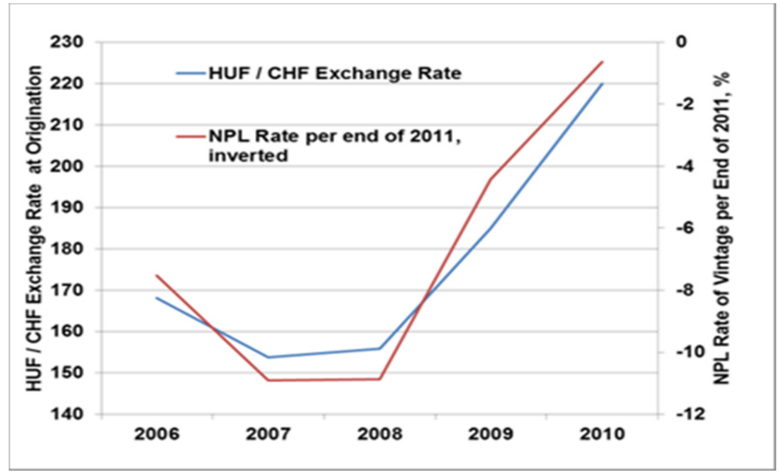
Negative Amortization Products Create Negative Equity, No Protections

- **FX Mortgages**
  - Hungary: CHF only market. Clear **correlation of NPLs with exchange rate and house price levels at origination.**
  - Poland: mixed LC and CHF market. Clear correlation of NPL with **CHF market share** at origination (2005 low, 2008 high), which itself is correlated with house price levels.

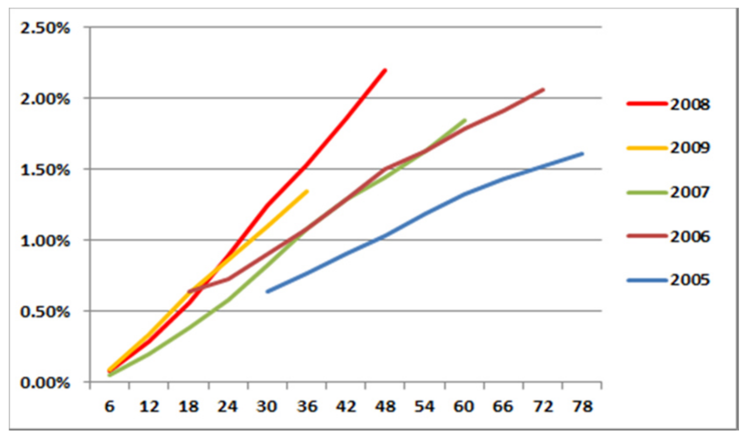
  High FX share, low FX exchange rate pushed house prices. As situation reversed, huge negative equity was created. In HU, by 2014 70% of CHF loans had LTV over 90%.

- **Does negative equity matter?**
  - No: default penalty (residual debt), loss of primary residence, stigma
  - **Yes**: U.S., UK and **Central European experiences.**

Hungarian NPL ratios by loan vintage, Dec 11



Poland NPL ratios by loan vintage, months after origination



Source: MNB, NBP, Finpolconsult.