The Integration of the EU Mortgage Credit Markets

Report by the Forum Group on Mortgage Credit

Internal Market Directorate General

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FOREWORD

I am delighted to present this Report of the Forum Group on Mortgage Credit. The Forum Group was created by the Internal Market Directorate General in 2003 to identify the barriers to further integration of the EU mortgage credit markets, assess the impact of these barriers on the functioning of the Internal Market and make recommendations to the Commission to tackle these barriers.

The Report is the result of a great deal of hard work by the dedicated expert members of the Forum Group, who were chosen to ensure a breadth of experience and geographical coverage. We, in the Commission, were very impressed by the quality of the discussions which have culminated in this Report. This confirms to us that such early consultation and input into the Commission policy formulation process is the best way forward in the post-FSAP era.

The Forum Group Report is a genuine blueprint on which a whole new policy can be based. Its publication marks the launch of the Commission process of policy development in this area.

We plan to present a Communication in the second half of 2005, which will set out our views on which of the almost 50 Recommendations of the Forum Group Report should be translated into Community policy, and how this should take place. The purpose of this Communication will be to widen the debate started within the Forum Group.

We will continue to consult widely and look forward to working with all stakeholders in the future.

ALEXANDER SCHAUB
Director General
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TABLE OF CONTENTS

Executive Summary 2

Recommendations 4

Introduction 9

Chapter 1 – Consumer Confidence 13
- I. Consumer Attitudes 13
- II. Consumer Protection Regulation 13

Chapter 2 – Legal Issues 21
- I. Conflict of Laws 21
- II. Client Credit-Worthiness 23
- III. Property Valuation 25
- IV. Cross-Border Forced Sale Procedures 27

Chapter 3 – Collateral Issues 29
- I. Registration 29
- II. Transfers of Mortgages Between Lenders 30

Chapter 4 – Distribution Issues 33
- I. Cross-Border Distribution 33
- II. Branches 34
- III. Intermediaries 35
- IV. Internet 37

Chapter 5 – Finance 39
- I. Funding 39
- II. The Development of a Secondary Loans Market 39
- III. Mortgage Funding Instruments 40

Conclusion 46

Annexes 47
- I. The Forum Group
- II. Consumer Information Research Findings (UK)
- III. Stages of the Mortgage Buying Process – Financial Services Authority (UK)
- IV. Profile for Risk-Related Criteria for Valuations – European Mortgage Federation
- V. The Eulis Initiative
- VI. The Euromortgage
- VII. Finance

EXECUTIVE SUMMARY

1. The EU mortgage credit markets form a substantial part of the EU economy. At the end of 2002, the value of outstanding residential mortgage loans stood at 4 trillion Euro, approximately 40% of EU 15 GDP. They are markets where there is scope for further integration, albeit that views differ on the precise nature of this scope and the costs and benefits of such integration. Markets remain unregulated by sector specific legislation at EU level. The only intervention thus far at this level, has been the support by way of Commission Recommendation, for the establishment of the Voluntary Code of Conduct on Pre-Contractual Information for Home Loans ('the Code of Conduct').

2. In March 2003 the Commission created the Forum Group on Mortgage Credit with a three-fold mandate to:

- identify the barriers to the smooth functioning of the Internal Market for mortgage credit;
- assess the impact of such barriers on the functioning of the Internal Market; and
- make recommendations to the Commission to tackle these barriers.

3. This Report of the Forum Group presents its findings and Recommendations. The Commission has compiled and edited the Group's work to produce the Report, which reflects the thinking of the Forum Group and not the Commission. The Commission's views, including specifically its responses to the Forum Group's Recommendations, will be set out in a Communication due to be adopted in 2005.

4. The members of the Forum Group are experts from all stakeholder groups relevant to the mortgage credit market including the banking sector, consumer organisations, insurers, chartered surveyors and civil law notaries. The members have been chosen to reflect the geographical spread of the EU at the time of the Group's formation, EU 15, which has been the focus of this Report. The Forum Group has operated against the background of the wide-ranging review of the Financial Services Action Plan, which is designed to identify future Commission priorities in the area of Financial Services.

5. The Forum Group has focussed on five main areas considered by its members to be key to an assessment of the state of integration of the EU mortgage credit markets: Consumer Confidence, Legal Issues, Collateral Issues, Distribution Issues and Finance. The different views expressed by Forum Group members have been reflected by the Commission to produce a Report which is rich in variety as well as depth of coverage. Such views do not necessarily reflect the views of any federations or associations to which experts may belong.

6. The main focus of the discussions on Consumer Confidence was the issue of (further) binding consumer protection legislation and the costs and benefits of such legislation. Recommendations here focus on the need for further research and guidance in the area of EU mortgage credit, encouragement of provision of the kind of information covered by the Code of Conduct and harmonisation of key areas such as annual percentage rate charge and early repayment fees. Views differed on the precise nature of such harmonisation and related matters, leading to Industry and Consumer Representative specific Recommendations, as well as common Forum Group Recommendations. Within the Legal Issues discussions, a major topic was the proposed revision of the Rome Convention to enable free choice of law in consumer mortgage credit contracts, a proposal hotly disputed by the Consumer Representatives in the Forum Group, because of the potential they considered it to possess, to have a detrimental impact on consumer confidence and protection. Other Recommendations in this area address matters as varied as credit databases, valuation standards and forced sale procedures. The Collateral Chapter includes a detailed assessment of

the difficulties foreign lenders face in accessing national land registrations systems, with consequential Recommendations. Also encompassed within the Collateral Issues heading, are Recommendations intended to facilitate the transferability of mortgages, including a proposal that the Euromortgage concept be explored by the Commission. The Distribution Issues chapter surveys four distribution channels, including the relatively untested Internet channel, a channel identified by the Forum Group as having limited potential for expansion, albeit one which requires safeguards to ensure sufficient consumer protection and confidence. The concluding Finance chapter undertakes an in-depth analysis of the potential for a more liquid secondary market and for more efficient use of existing funding mechanisms, both regarded as vital to deliver the market conditions considered conducive to further integration of the EU mortgage credit markets.

7. The Forum Group's deliberations have resulted in forty eight wide-ranging Recommendations.The Commission is asked to review these Recommendations as a complete package, as action only on any individual Recommendation is considered to be incapable of delivering further integration of this market.

RECOMMENDATIONS

INTRODUCTION

1 The Commission should adopt a definition of cross-border lending and monitor it with statistical data.

CONSUMER CONFIDENCE

Common Recommendations

2 There should be Commission funded research on the costs and benefits of further integration of the mortgage credit market.

3 Provision of the kind of information currently provided by means of the European Standardised Information Sheet created by the Code of Conduct should be encouraged by the Commission and at a stage which facilitates use and comparison of such information.

4 Consumer Representatives and most Industry Representatives advocate harmonisation by the Commission of Early Repayment Fees. There is divergence on the nature of such harmonisation. For further details see Recommendations 10 and 18.

5 There should be harmonisation by the Commission of the Annual Percentage Rate Charge (APRC), in relation to both the method of calculation and the basis of calculation. There is divergence on the nature of such harmonisation. For further details see Recommendations 11 and 16.

6 There should be Commission funded research on the value from a consumer perspective of pre-contractual information of the kind provided by the European Standardised Information Sheet created by the Code of Conduct.

7 The Commission should create and maintain an on-line guide on the main legal and other issues on cross-border mortgage lending.

Specific Consumer Representative Recommendations

8 The Commission should encourage efforts to produce a standardised format for mortgage loan contracts.

9 The Commission should introduce binding consumer protection rules for mortgage loan contracts on a minimum harmonisation basis, set at the highest level, covering the following areas:

- Duty to give 'best possible advice'. The demands and needs of consumers and the underlying reason for all mortgage credit advice given to consumers regardless of source (including branches and intermediaries) should be specified to consumers on a durable medium .

- The right of the consumer to redress (judicial and extra-judicial).

- The provision of pre-contractual summarised information at the earliest stage of contact between the consumer and the lender or intermediary showing in a standardised European Standardised Information Sheet type format: commission charges, administration or handling charges, total amount borrowed and payable (including APRC, calculation rate, compound period, operation of variable interest rates and total interest payable), the cost of bundled products (direct and the impact on interest), form of product, the exposure period and cost of the Early Repayment Fee (including worked examples of the charge) and amortisation tables.

10 The Commission should ensure that consumers are afforded the right to terminate a mortgage agreement at any time and in any circumstances. Any charge levied on the consumer seeking to exercise this right must be: (a)appropriate in length of exposure (i.e. Early Repayment Fee charged beyond the first few years of the agreement must not be allowed); (b) calculated in a fair and objective manner to reflect the cost (if any) incurred by the lender in the wholesale markets and subject to a statutory ceiling; and (c)clearly indicated in the pre-contractual summary document using worked examples.

11 There should be harmonisation by the Commission of the Annual Percentage Rate Charge, in relation to both the method of calculation and the basis of calculation. Consumer Representatives favour a broad definition including all associated charges, and minimum harmonisation.

12 The Commission should ensure that redress and enforcement mechanisms/binding rules offer consumers a minimum equivalent protection throughout the EU, at the very least at the highest level currently in existence.

Specific Industry Representative Recommendations

13 The Commission is invited to exclude all secured loans from the Consumer Credit Directive proposal, in line with the European Parliament First Reading, to ensure that mortgages are not subject to two separate legal regimes.

14 In those jurisdictions which have binding rules on pre-contractual information for mortgage credit offers, the Commission should ensure that such rules are aligned with the European Standardised Information Sheet format, so that only one set of rules apply.

15 The Commission should ensure that the Code of Conduct continues to be maintained, in its current form of self-regulation. In any event, before any further assessment of its operation, the methodology for such assessment should be discussed by all stakeholders.

16 The Commission should harmonise the Annual Percentage Rate Charge, in relation to both the method of calculation and the basis of calculation. Industry Representatives favour a narrow definition restricted to costs levied by the lender for its benefit at the time of the granting of the loan, and full harmonisation.

17 The Commission should ensure that legally enforceable caps on interest rates and on the variation of interest rates are removed.

18 The Commission should ensure that legally enforceable caps on Early Repayment Fees are removed. There is support amongst some Industry Representatives for a proposal that there should be full harmonisation of the conditions for exercising the right of early repayment, especially for fixed interest rate loans, and limitation of that right to circumstances involving sale of the property, unemployment or death. All Industry Representatives advocate that lenders should be entitled to ask for full compensation of losses (especially those linked to funding) and costs resulting from the early repayment.

LEGAL ISSUES

19 The Commission should ensure that the applicable (substantive) law for the mortgage deed and any related security agreement is the law of the Member State where the property is located (lex rei sitae).

20 Industry Representatives advocate that the Commission should ensure that the applicable law for the mortgage loan contract is defined by a general conflict of law rule based upon the principle of free choice. The Rome Convention should be amended accordingly, provided that certain essential standards are met. Member States should no longer be able to seek to impose any additional national consumer protection rules to cross-border mortgage loan contracts. For further details see Recommendations 13 – 18 on Consumer Confidence.

21 Consumer Representatives do not agree with Recommendation 20 that the applicable law for the mortgage loan contract should be defined by a general conflict of law rule based on the principle of free choice and accordingly reject the proposal for such an amendment of the Rome Convention. Instead they recommend the retention of the specific rules on consumer protections contained within the Rome Convention and advocate the additional protection described in Recommendations 8-12 on Consumer Confidence.

22 The Commission should implement a short-term solution consisting of :

- collecting information on existing credit databases in all Member States;
- promoting the development of a Memorandum of Understanding between the owners/controllers of such databases, to facilitate access to national databases by foreign lenders on the same conditions as the access offered to domestic lenders and to facilitate data comparability; and
- developing a project to assess the effectiveness of the Memorandum of Understanding during a pilot phase of 3-5 years.

23 The Commission should consider how to encourage Member States to develop positive (client indebtedness) as well as negative (level of default(s)) databases, taking into account the costs and benefits of such databases.

24 Industry Representatives advocate that the Commission should ensure that a financial institution which lends cross-border is allowed to:

- accept valuations prepared according to internationally recognised valuation standards of its choice, without being subject to additional national conditions; and

- instruct any valuation practitioner who is a member of an internationally recognised valuation body to carry out the valuation, without being subject to additional national conditions.

25 Industry Representatives advocate that the Commission should ensure that a financial institution which lends cross-border, and the valuer based in the country where the property is located, are able to accept mandatory regulations for standards or practitioners prevailing in either of their respective countries (mutual recognition of regulations).

26 Consumer Representatives advocate instead that the Commission should ensure that neutral international valuation standards prevail, or that there exists a single valuation standard ensuring comparability.

27 The Commission should recommend that high standards of valuation be made mandatory and that all valuation reports should consider core risk related criteria such as those recommended by the European Mortgage Federation (set out in Annex IV) where applicable.

28 The Commission should first:

- Perform an evaluation exercise of forced sales procedures within one year.

- Thereafter, monitor the functioning of forced sales procedures and assess results every three years. These results should be presented in the form of an official EU scoreboard on duration and cost of forced sale procedures in every Member State and lead to Commission advice/action for improvements.

29 Thereafter, if necessary, the Commission should promote measures to ensure that the duration of a forced sale procedure should not exceed a specified term, for example two years after the first step in the forced sale procedure.

COLLATERAL ISSUES

30 The Commission should ensure that:

- all charges affecting real estate must be registered in a Public Register in order to be binding on and take effect against third parties, regardless of their nature;

- the creation, modification or extinction of a charge on real property shall become effective vis-à-vis third parties only at the point of registration in the Public Register; and

- registered charges on real property in relation to the same estate shall rank in the order of priority disclosed in the Public Register.

31 For filings of applications for registration/notification, the Commission should allow Member States to decide that priority be determined according to the time at which the application was received (not actual registration). In this scenario, the Member State should ensure that filings of applications must be registered or rejected by the Public Register in the order of receipt.

32 The Commission should ensure that Public Registers make all relevant information available to all parties or their representatives.

33 The Commission should ensure that Member States provide that the responsible Public Register certifying authority should have state indemnity. In the event that such responsibility is delegated to a third party, such party shall be covered by appropriate professional liability insurance for an adequate sum.

34 The Commission should ensure that Member States do not maintain or institute additional 'legalisation'/'validation' requirements, for authentic instruments formally drawn up in other Member States.

35 More generally, the Commission should provide financial support to the EULIS initiative, to enable and encourage its expansion across the EU.

36 The Commission should ensure that links between mortgage debts and the collateral security are made more flexible. In countries where there is an existing requirement for strong accessoriness between the loan and the collateral, this should be replaced by an accessoriness agreement in the form of a private agreement between the lender and the owner of the mortgaged property. The relationship between the loan and the collateral can be dealt with in such a way as to allow it to be tailored to fit the needs of the parties.

37 The Commission should ensure that Member States allow the lender or any beneficiary of a charge on real property, to appoint a representative (Mortgage Register Representative) vis-à-vis the Public Register. His/her position should be disclosed on the Register and not have any effect on the legal framework of the Register. He/she should be entitled:

- to establish any abstract of title;
- to consent to a change in the respective ranking of charges over the real estate in question and to grant preferential rights between beneficiaries as shall be deemed appropriate;
- to consent to, apply and file any registrations and notifications;
- to consent to any change or transfer of the charge on behalf of (and in the name of) the owner of the charge; and
- to act on behalf of the owner of the charge in relation to the discharge or cancellation of the charge.

38 The Commission should explore the concept of the Euromortgage, for example by way of a study, to assess its potential to promote EU mortgage credit markets integration.

39 The Commission should encourage Member States to increase the transferability of mortgages by introducing pan-European Security Trust instruments.

DISTRIBUTION ISSUES

40 The Commission should assess and ensure equal treatment of local banks and foreign banks on the basis of the same business, same risks, same rules principle.

41 The Commission should revise the legislation covering cross-border services and establishment of branches to include the establishment of representative offices, in order to ensure that there are no disproportionate barriers to the establishment of such offices.

42 The Commission should introduce a supervisory system for independent intermediaries along the following principles: registration with a competent authority in the home Member State; possession of appropriate professional knowledge and ability (to be determined by home Member State including requirement that the intermediary to be 'fit and proper'); possession of professional indemnity insurance and a complaint/redress scheme in line with requirements for other intermediaries to ensure consistency. In addition, Consumer Representatives advocated that under such a system there should be declaration at the outset of the relationship between consumer and intermediary of all payments including every commission/fee, and that records should be kept of any information/advice given to consumers. In the context of this Recommendation, Consumer Representatives pointed to the need to consider their Recommendation 9, in particular, with its reference to a 'best advice' standard.

43 The Commission should review what mortgage transaction actions require written processes and/or a physical presence generally and review money laundering legislation in particular, to address current legal barriers to greater Internet use.

44 The Commission should ensure consistency, especially in relation to information requirements, between different directives affecting financial services products.

FINANCE

45 The Commission should harmonise legislation regarding segregation of assets, in order to ensure equal access to securitisation for originators located in different jurisdictions.

46 The Commission should enact legislation that recognises the legal separateness of a securitisation vehicle from an originator of assets in the event of the insolvency/bankruptcy of such an originator, even if the securitisation vehicle is part of the same group of companies as the originator.

47 The Commission should investigate and address tax distortions, in order to ensure the removal of differences in fiscal treatment between local and foreign lenders.

48 The Commission should investigate and address national legislation which prevents or hinders the pooling of mortgage collateral from different issuers based in different jurisdictions.

INTRODUCTION

THE FORMATION OF THE FORUM GROUP ON MORTGAGE CREDIT

1. Mortgage credit[1] is an area which is currently not covered by specific EU legislation. The main intervention at EU level thus far, has been the establishment of the Voluntary Code of Conduct on Pre-Contractual Information for Home Loans ('the Code of Conduct')[2] . In the light of the current state of integration and of the expected benefits which the EU could draw from a more integrated mortgage credit market, the Commission created an expert group in March 2003 to:

- identify the barriers to the smooth functioning of the Internal Market for mortgage credit;
- assess the impact of such barriers on the functioning of the Internal Market; and
- make recommendations to the Commission to tackle these barriers.

2. The composition of the Forum Group[3] was designed to include expert representatives from a wide variety of market participants and stake-holders, (such as the banking sector in all its diversity, insurers, consumers, civil law notaries and chartered surveyors), and to reflect as many EU national markets as possible. The EU markets here refer to pre-accession EU[4] , which has been the focus of this study.

3. The Forum Group has undertaken its work at a time of regulatory uncertainty, in particular due to the Consumer Credit Directive (CCD) proposal decision-making process. The Commission's original proposal was that the CCD should cover loans which are secured on property, but which are not intended for home purchase. At the time of the Forum Group's discussion, some such loans remain within the scope of the CCD proposal. The Forum Group's work has also been influenced by the evolving debate over the effectiveness and future of the Code of Conduct.

4. More generally, the Forum Group's work and Report form part of the post-Financial Services Action Plan (FSAP) process, the purpose of which is to review the existing FSAP and identify priorities for future EU action in the area of Financial Services. In this context, the Forum Group has noted the following principles from the FSAP Expert Group on Banking: "Further integration efforts should be subject to ex-ante analysis as to the costs and benefits of intervention. This should be supported by a comprehensive study of the patterns of retail markets. Removing obstacles should be pursued if the benefits are higher than the costs of implementation for both banks [and customers] and if integration delivers net benefits to the end customer. The Commission should define clear medium and long term goals to reach the single market. A realistic step by step approach with time-frame should be adopted to achieve further integration towards the end-goal of a competitive single market[5]."

5. The aim of the Forum Group has been to identify and focus on particular areas considered by the members to be key to an assessment of the potential for the further integration of the EU mortgage credit market, in order to provide the Commission with its expert overview of barriers and ways to address them. In this overall context, the Forum Group has examined the following five areas: Consumer Confidence, Legal Issues, Collateral Issues, Distribution Issues and Finance. Many of these areas are related and their assessment includes consideration of aspects that are common. Such aspects are, on occasion, reviewed from different angles within different sections of this Report.

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1 The focus of this Report is residential mortgage credit.

2 The Code, sponsored by consumer and industry associations, came into existence on 5th March 2001. It is supported by way of Commission Recommendation C(2001) 477. See Chapter 1 on Consumer Confidence for further details.

3 See Annex I for further information on the composition and working of the Forum Group.

4 Pre-Accession EU is also referred to in this Report as EU 15, with the new Member States joining on 1st May 2004 being referred to as EU 10.

5 The FSAP Expert Group Report on Banking is subject to consultation at the time of writing.

6. The Forum Group's Report will launch the Commission's process of policy formulation in the area of mortgage credit. This process, which will lead to a Commission Communication on the integration of the EU mortgage credit markets in 2005, will be facilitated also by a forthcoming Commission funded study on the costs and benefits of the further integration of the EU mortgage credit market which will cover the whole of the EU, and wider consultation amongst stakeholders.

THE EU MORTGAGE CREDIT MARKET

7. Mortgage credit is on the rise the EU. Mortgage credit to consumers dominates the total mortgage lending market. In countries where such data is available, this represents between 70% and 90% of all mortgage lending[6]. The value of outstanding residential mortgage loans has doubled in nominal terms since 1991. At the end of 2002, this stood at approximately 4 trillion euro, which represents about 40 % of the EU 15 GDP

8. The growth in residential mortgage activity since 1991 has varied significantly between Member States. The most noticeable increases in mortgage debt within EU 15 have been in Spain, Portugal, Greece and the Netherlands. In all of these countries, mortgage debt has increased by at least ten percentage points since 1998. Within EU 10, the most noticeable increases have been in Slovakia, Lithuania, Latvia and Poland, although it must be noted that in these Member States, mortgage markets are mostly of relatively modest size in comparison to EU 15[7]. Overall, the EU 15 have experienced an average yearly growth rate of 8% in mortgage debt for this period, while the EU 10 grew by an average of 50% a year[8].

9. The largest markets in terms of volume of outstanding loans are Germany, the United Kingdom, the Netherlands and France. That said, there are notable differences in the relative sizes of the national mortgage markets resulting from differences in the economic, legal, fiscal, political and historical frameworks within which mortgage lenders operate. In 2002, outstanding mortgage debt, expressed as a percentage of GDP, ranged from 88% in the Netherlands to 11% in Italy. In addition, structural differences in the national property and construction markets, differing house price levels and variations in household formation trends, all contribute to painting a picture of an extremely heterogeneous European mortgage market

LEVEL OF INTEGRATION

10. It is not easy to assess the level of integration in a given market. The application of the existing indicators classically used to measure market integration in the mortgage credit market can offer inconsistent results. This is illustrated by the two indicators of integration used most often: the level of cross-border activity and the extent of price convergence. As shown below, they provide conflicting benchmarks for the level of integration in the EU residential mortgage lending market. That said, they do provide sufficient intelligence to justify further examination, particularly given the relatively low level of research thus far into the integration of the EU mortgage markets.

Cross-border Mortgage Credit

11. There are many examples of lenders offering mortgage credit across borders, albeit that it should be noted that there is no generally understood definition of cross-border mortgage credit as such, making a conclusive assessment of this phenomenon problematic. German mortgage banks began to offer commercial mortgage loans in the Netherlands, following this with similar activity in the UK, France and Spain. Some French and Danish lenders offer home loans across borders. The Commission is aware also of a Dutch lender offering loans on the Belgian market and of a UK lender offering loans over the Internet to the Irish market.

12. In many of these examples, lenders operate in different Member States through branches, subsidiaries or joint ventures, that is, through some sort of establishment in the Member State in question. However, lending across borders without the need for any sort of establishment by the lender in the Member State

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6 Hypostat 1992-2002, 'Mortgage and Property Markets in the European Union and Norway', European Mortgage Federation – source for all figures unless stated otherwise.

7 European Savings Banks Group calculations based on data from EU National Banks, Eurostat (for the GDP), European Commission Budget Directorate General (for the euro exchange rate) and the US Mortgage Bankers' Association.

8 See Footnote 7.

where the consumer debtor resides, represents less than 1% of European mortgage credit activity. Thus, used as an indicator, the current level of cross-border lending points to a low level of integration in the EU mortgage credit market.

Price convergence

13. The recent study by Mercer Oliver Wyman[9] has shown that differences in prices for mortgage credit, between the various Member States surveyed, are not significant. The authors concluded that "overall price levels adjusted for product differences are currently uniform across markets[10]". The adjusted price range for eight EU national markets was estimated at around 64bp.

14. Thus, by way of contrast to the indicator of cross-border mortgage credit, this indicator could be regarded as evidencing a high level of integration in the EU mortgage lending market.

BENEFITS OF INTEGRATION

15. Supply-side studies show that significant benefits could result from further integration of EU mortgage markets[11].

16. For example, the Mercer Oliver Wyman study estimates that improvements in efficiency resulting from further integration, could deliver an increase in EU residential mortgage balances of between 0.15% and 0.30%, while greater product availability could result in a market expansion of up to 10%, and deliver a further increase in mortgage balances of between 0.15 and 0.30%.

17. The authors of this study identified also the following general benefits:

- For consumers, greater choice of products and lower prices. There could be improved access to mortgage credit for those categories of consumers currently excluded from or marginalised in this market, as well as provision of products which are more closely aligned with borrowers' needs. Competition between lenders could also result in lower mortgage interest rates.

- For lenders, the creation of a deeper and more liquid secondary market in mortgage debt would act to lower funding costs. Integration would bring reductions in credit and risk management costs as a result of diversification and scale of activity, lower servicing costs as a result of the increase in lenders and servicers, and more effective capital flow.

18. Of course, care would need to be taken to ensure that the benefits to be achieved from a greater integration of the EU mortgage credit market encompass quality as well as quantity of choice for consumers, and that consumer confidence is enhanced. There is concern that greater choice has the potential to lead to confusion, given the complexity and diversity of mortgage products, information asymmetry (sometimes combined with confusion marketing), and weak consumer influence. In addition, there is concern that the imperative to create a single market might lead to a removal of perceived barriers to integration, where such barriers consist of measures designed to address particular national issues and problems. Both the risks and consequences of consumers making ill-advised decisions are significant, making it crucial that further integration does not occur at the expense of a sufficient level of consumer protection and of consumer confidence.

Recommendation

1 The Commission should adopt a definition of cross-border lending and monitor it with statistical data.

9 'Study on the Financial Integration of European Mortgage Markets'. Mercer Oliver Wyman, commissioned by the European Mortgage Federation, 2003.

10 pp 35. See Footnote 9.

11 Other studies form the backdrop to the work of the Forum Group. They include the following. The FSAP Expert Group Report on Banking (May 2004), which made recommendations on the approach to be taken in efforts to further integrate the EU financial services markets. The European Financial Services Roundtable Report on Consumer Protection and Consumer Choice (February 2004), which proposed a set of principles to be taken into account in considering consumer protection regulation. The Eurobarometer Report (June 2004), which reviewed attitudes of consumers to the purchase of financial services products.

CHAPTER 1: CONSUMER CONFIDENCE

I. CONSUMER ATTITUDES

19. A major factor in consumer attitudes to mortgage credit purchases, domestic or cross-border, is, according to all research, price. In addition, various other factors have been identified including the following: the desire for security, focus on anticipated regret about making the wrong choice, information overload and the associated search for simplicity of choice. It is considered that in relation to mortgages, more than in relation to other financial services products, trust in and knowledge of the service provider is very important, a factor reflected in the choice by most consumers of local and familiar lenders.

20. According to the recent Eurobarometer Survey[12], an average of only 1% of over 16,000 respondents in the EU had ever obtained a mortgage loan in another country. Moreover, it would appear that at this stage, such activity is largely confined to border region properties and holiday homes.

21. Further, the Eurobarometer Survey found that over 85% of consumers across Europe would not consider buying a mortgage in another Member State in the next five years, demonstrating that interest in cross-border mortgages was the second lowest (to pensions) level of interest in cross-border purchases within all financial services products surveyed. Information discrepancies concerned most respondents to differing degrees, with a majority of consumers finding mortgages difficult or very difficult to understand. Following on from this, there was concern about language barriers. Legal barriers were also cited by respondents as contra-indicators to shopping for financial services across borders.

22. However, interest in cross-border mortgages in the future seems higher, albeit that there is concern that this interest in itself cannot be regarded as a safe indicator of untapped demand.

23. More generally, surveys on financial services point to an affinity with local lenders. The most recent survey, by KPMG[13], revealed a clear preference for familiar lenders. In all ten countries surveyed, an average of 72% of respondents indicated that they had been with their banks for at least 6 years.

24. In summary, this outline assessment of consumer attitudes reveals that information, language and legal barriers remain issues hindering further cross-border activity in the arena of financial services generally and mortgages in particular, with consumers tending to opt for the lender they know (of). That said, according to lenders which operate across borders, their experience demonstrates that consumers are willing to take out loans offered in that context, when those products are new or suitable, provided that they are not more expensive than local products.

II. CONSUMER PROTECTION REGULATION

25. Mortgage loans are subject in every Member State to national rules and coverage by general EU legislation[14] on particular aspects of consumer protection such as consumer contract terms. They are also the subject of a Code of Conduct, to which lenders[15] from EU jurisdictions may subscribe.[16]

Common Strands in National Rules

26. Pre-contractual Information: Almost all countries impose information requirements at the advertising stage. Specific pre-contractual information is covered by the Code of Conduct where applicable and by national legislation in many Member States.

12 Eurobarometer Report 2004.

13 'Banking Beyond Borders: Will European Consumers Buy it'. KPMG Financial Services March 2004 UK.

14 This includes the Door-Step Selling Directive, 85/577/EC, the Misleading & Comparative Advertising Directive, 84/45/EC updated by 97/55/EC, the Unfair Contract Terms Directive 93/13/EC, the Electronic Signature Directive 99/93/EC, the E-commerce Directive 01/31/EC, the Distance Marketing of Financial Services Directive 02/65/EC, the Data Protection Directive 95/46/EC and the Insurance Intermediaries Directive 02/92/EC.

15 3,800 at the time of writing.

16 Credit intermediaries are not signatories to the Code.

27. Interest Rate: In most countries, the disclosure of an Annual Percentage Rate of Charge (APRC) is compulsory at the pre-contractual stage, albeit that the way that the APRC is calculated differs between Member States.

28. Conclusion of the credit agreement: In a majority of countries, a compulsory written offer containing information elements relating to the future contract, must be given to the borrower.

29. Early Repayment: A right of early repayment is provided for in 11 Member States and is generally subject to conditions.

30. Duty to Advise: There is no general legal duty to provide advice on the suitability of the credit offer in any Member State.

Differences in National Rules

31. Some rules exist in only few countries: The following are examples of the spread of rules in individual Member States. A right of reflection (FR), a right of withdrawal in certain circumstances (DE), pre-contractual information in the form of a binding offer (ES, FR, IRL), an obligation to consult databases (BE, NL), a link between the property transaction contract and the credit contract (FR), joint and several liability (SW), application of the consumer protection law to guarantors (GR and UK) and contractual subrogation (ES).

32. National rules in the same area can differ greatly. An example of this is the right to early repayment. While this right exists in almost all Member States, the conditions for exercising the right and the costs involved can, however, differ greatly. In several countries, the loan can be repaid at any time. In Spain, the maximum early repayment charge that can be levied on loans with a variable rate of interest is 1% of the outstanding loan for loans entered into before 27th April 2003 and 0.5% for certain loans entered into thereafter (currently a minority of all such loans). In France, the indemnity the borrower can be charged for early repayment is capped at 3% of the outstanding capital (or semester of interest payments which does not apply in practice). In Germany, early repayment might not be permitted for the duration of any fixed interest rate period for the first ten years, except in some circumstances such as those involving the sale of the home constituting the collateral. In these cases, early repayment is also subject to an indemnity, which must cover all losses. Repayment is permitted and without such an indemnity after the end of a fixed rate period and in any case after ten years.

Information Provision: The Code of Conduct

33. The objective of the Code of Conduct is to introduce transparency and consistency in the provision of information to consumers by lenders about mortgage credit offers. It creates the European Standardised Information Sheet (ESIS). This exists alongside binding national rules where applicable, for example in France and Ireland.

Main barriers identified

Differences in Rules

34. There is some concern amongst Industry Representatives that differences in national protection rules and the cost of consumer protection hinder cross-border activity by lenders. It is argued that such differences constitute barriers to the entry of new competitors into a given market (for example, a cap on early repayment indemnity). It is considered that such differences could result also in a distortion of competition for national lenders. If foreign lenders were able to offer services designed only according to their own national legislation, which arguably might not impose the same kinds of limitations on them, they would be in a more advantageous position than national providers. They would be able to offer less protected but potentially cheaper loans. It might also be misleading for consumers, who often attach primary importance to price. On the other hand, some Industry Representatives argue that competition between lenders from different countries would not be possible, if foreign lenders offering products with different product profiles were not able to enter foreign markets. If national supervisors could refer to clauses of general interest to prevent foreign lenders from offering products with different product profiles, consumers would be denied the opportunity for greater choice.

35. Consumer Representatives disagree with the categorisation of different rules as a 'barrier' . They stress that any diminution of national consumer protection rules, is bound to affect consumer confidence and activity, as consumers expect to benefit from the same level of protection in the Internal Market as in their home country.

Necessity for local contact

36. Given the complexity of the mortgage credit product and its status as a consumer's largest value 'purchase', there is and may continue to be a reluctance to deal with lenders who are not local and known to consumers. This may constitute a barrier to success by foreign lenders. In this context, there is an acknowledgement by all that a local presence is a very important factor for consumer confidence in assessing available offers for mortgage credit. Here, unlike other financial services products, given the long-term and particular nature of the relationship between consumer and lender, consumer confidence appears to require familiarity with and easy access to a lender.

37. This should not, however, prevent lenders from establishing processes which enable economies of scale. For example, they could use their home market products and/or their home processes, adapting them to local specifications. The degree of adaptation required would depend on each Member State's legal and social context. However, such adaptation comes at a cost and could prevent lenders from offering products cross border. At the same time, lack of adaptation can have a detrimental effect on the willingness of consumers to engage with cross-border lenders not abiding with destination country consumer protection rules.

Comparability of Offers

38. The different consumer protection rules affect directly another aspect relevant to further integration, that of comparability of different products from different lenders and jurisdictions. If important aspects of mortgages and related products are calculated and conveyed differently, the consumer faces difficulty in making accurate and meaningful comparisons between different kinds of offers from different lenders based in different jurisdictions. At the same time, consumers are not in a position to compare different consumer protection regimes, especially those contrasting with their own familiar consumer protection rules This is a significant barrier in a highly complex market, especially as the product in question is an extremely high value product for consumers, their most expensive 'purchase' and monthly outgoing.

Information Provision

39. Whilst the Code of Conduct introduces a system of uniformity of information provision in core areas, this is limited to the information covered by it. In addition, there appear to be divergences in the way that aspects of the Code of Conduct are interpreted, such as timing of the provision of the ESIS, which affect its ability to introduce some level of harmonisation in this area. Following on from this, the Code of Conduct is of course voluntary, so its effectiveness in removing barriers of consistency in information provision is dependant on its membership and on voluntary compliance. Finally, its operation is affected also by the existence of mandatory rules covering information provision, another factor which introduces divergence affecting both lender and borrower in a detrimental way.

Discussion

40. There was broad agreement on the principles that should inform thinking and recommendations in this area. There should be trust in the consumer-supplier relationship. Consumers must be confident that any offer is bound by a significant amount of effective European-wide consumer protection, which covers all relevant areas. Consumer Representatives considered that these areas should include advertising, advice, information provision, contracts, right to exit, transparency and flexibility.

41. On Consumer Information, all agreed on the usefulness of ESIS, with support for an extension to the information to be provided in this way amongst Consumer Representatives. It was argued that the extension should include coverage of advice (including disclosure of commission/ costs/ administration or handling charges), total amount borrowed and payable (including APRC, calculation rate, compound period, operation of variable interest rates with illustrative examples and bundled product costs), form of product, right of withdrawal, costs of early termination with examples and amortisation tables. These recommendations were made on the basis of several consumer research projects highlighting inefficiency in the manner and timing of current information provision on mortgages[17]. Consumer Representatives considered that this research provided extensive and indisputable evidence that consumers would find additional and improved summary information useful in their purchase decisions. There was concern expressed by some Industry Representatives within the Forum Group that recommendations for additional information to be provided were not based on sufficient evidence that there was an information gap or that consumers would in fact find such additional information useful.

42. There was divergence of views on whether the ESIS framework should remain voluntary or be translated into legislation and therefore become binding. But on timing, there was a consensus that such information needed to be provided to the consumer at a stage when it was meaningful, that is, when it could still be used to facilitate comparisons between different offers. As to the precise identification of such a stage, this could differ depending on the jurisdiction/participant in question. On this point, Consumer Representatives pointed to the UK Financial Services Authority (FSA) model[18] of the different stages of purchase of a mortgage, as helpful in clarifying the different stages at which information could and should be provided, while acknowledging that the FSA model was perhaps more comprehensive than necessary at EU level.

43. All agreed that ideally the consumer should have sufficient information to enable him/her to choose a suitable product. Against this background, care needed to be taken that a lack of necessary information, inaccurate information, or even excessive information, did not contribute to an ill-advised choice. Therefore, a balance needed to be struck between providing the appropriate amount of relevant information, while taking care to avoid overwhelming consumers with information that was superfluous at the stage in question. In this regard, it was acknowledged that there were limitations to the effectiveness of standardised information requirements, given the complexity and multi-faceted nature of mortgage and related (bundled) products and variations in consumer financial literacy.

44. On substantive Consumer Protection, there was agreement amongst Consumer Representatives and some Industry Representatives on the need for harmonisation in some areas, for example, Annual Percentage Rate Charges (APRC) and Early Repayment Fees (ERFs), albeit that there was disagreement on the nature and content of such harmonisation. Other Industry Representatives believe that harmonisation of rules on ERFs could have detrimental effects on product variety and the cost profile of mortgages in the EU.

45. On formulation of the APRC, Consumer Representatives favoured a broad definition for a number of reasons. It was considered that the consumers needed to know all elements of costs involved, in order to assess their ability to repay the loan. This would not be facilitated if such costs were calculated differently. A narrow definition was likely to have the effect that excluded aspects of costs would allow the offer to be presented in a way that made it appear to be cheaper than it was. Industry Representatives on the other hand, favoured a narrow definition of APRC restricted to those costs levied by the lender for its benefit, that is, excluding additional elements which could vary from one Member State to another. They argued that such an approach would facilitate greater comparability than that advocated by Consumer Representatives.

17 The most extensive research was conducted by the UK Financial Services Authority, involving four phases of in-depth interviews and testing with a total combined sample size of 294 consumers. See Annex II for further details.

18 See Annex III for further details.

46. Some Industry Representatives favoured harmonisation of the conditions for exercising the right to early repayment, especially for fixed rate loans. In addition, they advocated that there should be limitation of any right to early repayment to circumstances involving sale of the property, unemployment or death. Furthermore, all Industry Representatives considered that they should not be prevented from claiming compensation for all losses caused by any such early termination through ERFs. This was of particular concern in relation to financial institutions offering fixed rate mortgage credits. According to supervisory requirements, they were required to apply the matching principle to capital market-based funding, in order to avoid taking risks of maturity transformation and interest rate mismatches.

47. Consumer Representatives took the view that consumers in all Member States should be given the right to withdraw from their mortgage loan contract at any stage and in any circumstances. It was acknowledged that such a right could (in some situations) result in a market cost to the lender, which would have to be passed on to the consumer as an ERF. It was argued that such fees must be:

    1) Appropriate in Length: ERFs should only be payable within a limited time frame, for example, three to four years into the loan.

    2) Limited in Amount: the ERF must be calculated in a fair and objective manner to reflect the cost (if any) incurred by the lender in the wholesale markets. In order to stimulate competition and consumer mobility, and given the integration of wholesale markets resulting from a single currency and interest rate, Consumer Representatives saw merits in a statutory ceiling on ERFs. Consumer Representatives point to a comparison study[19] of the market rates in countries where such caps are in force with countries where suppliers have unlimited powers to impose fees, which they considered demonstrated that such caps do not hinder but even promote consumer confidence and fair competition.

    3) Transparent: consumers have a right to know at the earliest possible stage what the ERF would be and how it would be calculated. The pre-contractual summary document (such as the ESIS) must contain a section stipulating when the ERF applies and its likely amount, to be provided in the form of worked examples, with clarification of the illustrative nature of the examples.

48. More generally, there was concern expressed by some that caps on ERFs needed further thought, as they could have unintended consequences. Lenders were concerned that products could effectively be regulated out of the market. Such concerns were part of and fed into the generally supported recommendation for further research into this area.

49. On the Code of Conduct generally, all Consumer Representatives and one other member of the Forum Group expressed concern about its non-binding nature and the results of the recent study commissioned by the European Commission[20] into its operation, demonstrating a disappointing lack of compliance amongst Code subscribers. Industry Representatives considered that the Code of Conduct had not been given a sufficient opportunity to demonstrate its worth (and justify the investment in it by industry), that the study had been flawed, and that the Code remained the most effective mechanism for accession countries to reach an acceptable level of regulation in this area. Moreover, they argued that it was an existing effective mechanism that could in any event be replaced by binding rules only through a lengthy and complex process.

50 On approach, there was a general divergence between Consumer and Industry Representatives. Consumer Representatives favoured minimum harmonisation pitched at a high level of consumer protection, maintaining at the very least the existing level of national protections. This was considered to be necessary for consumer confidence and greater cross-border activity and for any increase in choice to result in enhanced quality of choice as well as quantity. Those Industry Representatives favouring harmonisation preferred instead full harmonisation in targeted areas, with removal of national rules, in order to facilitate the involvement of lenders in cross-border activity, without the need to operate within twenty five different sets of rules, which would stifle further integration.

19 'Vorfälligkeitsentschädigung in Europa'. Institute for Financial Services e.V, Hamburg, 2004.

20 'Monitoring the Uptake and Effectiveness of the Voluntary Code of Conduct on Pre-Contractual Information for Home Loans'. Institute for Financial Services e.V, Hamburg, 2003.

51. On method of proceeding, Consumer Representatives favoured legally binding rules, while the vast majority of Industry Representatives strongly supported self-regulatory mechanisms such as the Code of Conduct. The Consumer Representatives' position was influenced by their concern about the non-binding nature of self-regulation, its lack of comprehensive compliance mechanisms, limited constituency and lack of scope and depth. There was an acknowledgement that in some circumstances, within national markets, self-regulatory mechanisms could and did work effectively, but concern that such mechanisms had been unsuccessful in some arenas and in any event did not translate well into the more diverse and complex intra-jurisdictional arena. As regards Industry Representatives, their view was influenced by their perception of self-regulation as a more flexible and adaptable mechanism. That said, there was concern by lenders in jurisdictions where there were legal requirements similar to those enshrined in the Code of Conduct (for example, Spain and France), that there was confusion in such circumstances about which regime would apply.

52. More fundamentally, there was discussion about the costs and benefits of consumer protection measures. Lenders were concerned about the cost to them and the industry of consumer protection measures such as caps on ERFs, which they considered have resulted in huge losses for banks during recent decades as demonstrated in studies such as that by Professor Moulliard[21].

53. Consumer Representatives argued that the absence of adequate consumer protection would have a detrimental effect on consumer confidence and activity and therefore on the economy generally. Further, relying on the comparison study mentioned already, they considered that consumer protection measures such as caps on ERFs facilitate mobility and competition, thereby enhancing the efficiency of the market

54. In this context, there was support from all sides for an analysis of the costs of any further regulation and the benefits of such regulation, in order for an assessment to be made of the appropriate level of intervention, where the benefits of regulation for the further integration of the EU mortgage market justified the costs.

Recommendations

Common Recommendations

2 There should be Commission funded research on the costs and benefits of further integration of the mortgage credit market.

3 Provision of the kind of information currently provided by means of the European Standardised Information Sheet created by the Code of Conduct should be encouraged by the Commission and at a stage which facilitates use and comparison of such information.

4 Consumer Representatives and most Industry Representatives advocate harmonisation by the Commission of Early Repayment Fees. There is divergence on the nature of such harmonisation. For further details see Recommendations 10 and 18.

5 There should be harmonisation by the Commission of the Annual Percentage Rate Charge (APRC), in relation to both the method of calculation and the basis of calculation. There is divergence on the nature of such harmonisation. For further details see Recommendations 11 and 16.

6 There should be Commission funded research on the value from a consumer perspective of pre-contractual information of the kind provided by the European Standardised Information Sheet created by the Code of Conduct.

7 The Commission should create and maintain an on-line guide on the main legal and other issues on cross-border mortgage lending.

21 'Immobilier: les renégociations continuent'. Banque No 600, February 1999.

Specific Consumer Representative Recommendations

8 The Commission should encourage efforts to produce a standardised format for mortgage loan contracts.

9 The Commission should introduce binding consumer protection rules for mortgage loan contracts on a minimum harmonisation basis, set at the highest level, covering the following areas:

- **Duty to give 'best possible advice'. The demands and needs of consumers and the underlying reason for all mortgage credit advice given to consumers regardless of source (including branches and intermediaries) should be specified to consumers on a durable medium.**
- **The right of the consumer to redress (judicial and extra-judicial).**
- **The provision of pre-contractual summarised information at the earliest stage of contact between the consumer and the lender or intermediary showing in a standardised European Standardised Information Sheet type format: commission charges, administration or handling charges, total amount borrowed and payable (including APRC, calculation rate, compound period, operation of variable interest rates and total interest payable), the cost of bundled products (direct and the impact on interest), form of product, the exposure period and cost of the Early Repayment Fee (including worked examples of the charge) and amortisation tables.**

10 The Commission should ensure that consumers are afforded the right to terminate a mortgage agreement at any time and in any circumstances. Any charge levied on the consumer seeking to exercise this right must be: (a)appropriate in length of exposure (i.e. Early Repayment Fee charged beyond the first few years of the agreement must not be allowed); (b)calculated in a fair and objective manner to reflect the cost (if any) incurred by the lender in the wholesale markets and subject to a statutory ceiling; and (c)clearly indicated in the pre-contractual summary document using worked examples.

11 There should be harmonisation by the Commission of the Annual Percentage Rate Charge, in relation to both the method of calculation and the basis of calculation. Consumer Representatives favour a broad definition including all associated charges, and minimum harmonisation.

12 The Commission should ensure that redress and enforcement mechanisms/binding rules offer consumers a minimum equivalent protection throughout the EU, at the very least at the highest level currently in existence.

Specific Industry Representative Recommendations

13 The Commission is invited to exclude all secured loans from the Consumer Credit Directive proposal, in line with the European Parliament First Reading, to ensure that mortgages are not subject to two separate legal regimes.

14 In those jurisdictions which have binding rules on pre-contractual information for mortgage credit offers, the Commission should ensure that such rules are aligned with the European Standardised Information Sheet format, so that only one set of rules apply.

15 The Commission should ensure that the Code of Conduct continues to be maintained, in its current form of self-regulation. In any event, before any further assessment of its operation, the methodology for such assessment should be discussed by all stakeholders.

16 The Commission should harmonise the Annual Percentage Rate Charge, in relation to both the method of calculation and the basis of calculation. Industry Representatives favour a narrow definition restricted to costs levied by the lender for its benefit at the time of the granting of the loan, and full harmonisation.

17 The Commission should ensure that legally enforceable caps on interest rates and on the variation of interest rates are removed.

18 The Commission should ensure that legally enforceable caps on Early Repayment Fees are removed. There is support amongst some Industry Representatives for a proposal that there should be full harmonisation of the conditions for exercising the right of early repayment, especially for fixed interest rate loans, and limitation of that right to circumstances involving sale of the property, unemployment or death. All Industry Representatives advocate that lenders should be entitled to ask for full compensation of losses (especially those linked to funding) and costs resulting from the early repayment.

CHAPTER 2: LEGAL ISSUES

I. CONFLICT OF LAWS

55. 'Conflict of law' in this context, is intended to refer to the conflict between different consumer protection and other rules prevailing in different jurisdictions.

56. The mortgage transaction consists of two separate contracts, the mortgage loan contract and the constitution of the collateral (mortgage deed).

57. As regards the mortgage loan contract, the Rome Convention[22] provides the general principle of free choice of applicable law, although Article 5 of the Convention enshrines specific rules for consumer contracts. With regard to the constitution of the mortgage collateral, the principle of 'lex rei sitae', that is, the law of the country where the property is situated, applies. Finally, in countries where a strong linkage exists between the mortgage deed (collateral) and the loan contract, such as France and Austria, lex rei sitae might be extended to the loan contract.

58. Thus the following jurisdictions may apply to a mortgage loan contract, demonstrating the potential for legal uncertainty for cross-border mortgage contracts: (i) the jurisdiction of the home country of the lender, (ii) the jurisdiction where the property is situated, or (iii) the jurisdiction where the consumer is domiciled.

59. Conflict of law rules need to address both the mortgage loan contract and the mortgage deed, in order to produce appropriate and transparent solutions for cross-border borrowers and mortgage lenders. They should also address security agreements concluded in those countries where non-accessory mortgage collaterals exist and need to be linked to the loan contract by a specific agreement[23].

Main barriers identified

Confusion about applicable law

60. Some Industry Representatives are of the view that legal uncertainty about the applicable law is a major barrier to cross-border mortgage lending. Others consider that of equal importance are factors such as consumer confidence and a preference for proximity and close customer-lender relationships.

Member State Attitudes

61. Industry Representatives consider that Member States' attitudes to infringements of their consumer protection legislation (including the potential ultimate sanction for such infringement of rendering the mortgage loan contract void), discourages lenders from lending across borders to consumers. Consumer Representatives consider rather that consumer confidence results from such consumer protection, which cannot therefore be regarded as a barrier to cross-border activity. They doubt the extent to which such consumer confidence would be improved only by the applicability of foreign legislation to consumer contracts.

22 Convention on the Law applicable to Contractual Obligations (80/934/EEC).

23 A Security Agreement is defined for our purposes as a contract outlining the intended use by the contracting parties of the mortgage collateral. For further discussion on the 'accessory' concept, see Chapter 3 on Collateral Issues.

Discussion

62. The Forum Group considered that there was no evidence to support a view that the mortgage deed and the loan contract must always be governed by the same jurisdiction. There appeared to be no obstacle to the coverage of the mortgage deed by the law of one country and the coverage of the loan contract by the law of another country. This view applied also to countries with a strong accessory linkage between the loan contract and the mortgage deed, as, for example, where both contracts are part of one single authentic instrument[24].

63. That said, Industry Representatives considered that it was very important to introduce one single conflict of law rule, in order to determine the applicable law. They were convinced that the mandatory and systematic application of the law of the consumer's residence to cross-border loan contracts, would suffocate further market integration. They indicated that credit institutions were not able to provide 25 different but competitive and cost-efficient home loan products within the EU.

64. Thus many Industry Representatives were of the view that in order to benefit from competitive cross-border loans and product variety, consumers should be allowed to submit the mortgage loan contract to the jurisdiction of the mortgage lender's home country. Such 'mutual recognition' was, they considered, vital to boost market integration and facilitate lender competitiveness. They argued that consumer protection could be ensured by requiring the mortgage lender to fully inform the borrower about the mortgage product. Alternatively, sufficient consumer protection standards could be introduced as a basis for such mutual recognition.

65. Other Industry Representatives, concerned about the applicability of mutual recognition, pointed out that its effect would be restrained by the applicability of Member States' legislation falling with the 'general good' arena, as allowed by EU banking legislation[25]. They argued that targeted harmonisation would be a more effective way to achieve the goals of a single market. They were of the view that in retail banking, tailor-made services and consumer confidence are of the utmost importance. Therefore, there was a natural process of adaptation of retail products or services to local demand. The application of the principle of mutual recognition in the area of mortgage lending would, in their view, lead to a distortion of competition and clearly run counter to current market trends and therefore greatly upset practices at both industry and political level, having a potentially detrimental impact on consumer confidence.

66. Consumer Representatives shared this concern about mutual recognition. They argued that mutual recognition and the mere application of foreign legislation to their contracts would start a race to the bottom as far as consumer protection was concerned and therefore do little to address consumer confidence and quality of choice.

67. Consumer Representatives were also sceptical about the apparent benefits of the 'free choice of contract law' for consumers given the complexity and lack of knowledge about home jurisdictions, never mind others. The free choice of law was considered to be very much an illusion, in that consumers would have to accept the choice of law offered by the lender. Consumer confidence would suffer further in this respect, if the level of consumer protection enjoyed under such a choice was lower than that afforded by domestic legislation. In any event, expecting consumers to be able to make an informed choice between 25 sets of national laws did not appear realistic to them. They argued that the complexity of products and information asymmetry limit drastically any potential benefits consumers could gain from any extension of choice. They advocated minimum harmonisation through binding rules to ensure a high level of consumer protection. Consumer Representatives considered that for the most important financial decision in their lives, consumers expect to benefit from at least as high a level of consumer protection as that prevailing under their national law.

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24 This is, for example, lender practice in France. The term authentic instrument refers to a notary act providing for a link between the loan contract and the mortgage deed.

25 Article 22§5 of Directive 2000/12/EC of the European Parliament and the Council relating to the taking up and pursuit of the business of credit institutions.

Recommendations

19 The Commission should ensure that the applicable (substantive) law for the mortgage deed and any related security agreement is the law of the Member State where the property is located (lex rei sitae).

20 Industry Representatives advocate that the Commission should ensure that the applicable law for the mortgage loan contract is defined by a general conflict of law rule based upon the principle of free choice. The Rome Convention should be amended accordingly, provided that certain essential standards are met. Member States should no longer be able to seek to impose any additional national consumer protection rules to cross-border mortgage loan contracts. For further details see Recommendations 13 – 18 on Consumer Confidence.

21 Consumer Representatives do not agree with Recommendation 20 that the applicable law for the mortgage loan contract should be defined by a general conflict of law rule based on the principle of free choice and accordingly reject the proposal for such an amendment of the Rome Convention. Instead they recommend the retention of the specific rules on consumer protections contained within the Rome Convention and advocate the additional protection described in Recommendations 8-12 on Consumer Confidence.

II. CLIENT CREDIT-WORTHINESS

68. The concept of Client Credit-Worthiness (CCW) relates to client borrowing capacity, reflecting the ability (and willingness)[26] of the client to repay the loan. This concept is considered by financial institutions to be the cornerstone of client evaluation in mortgage (and other) lending transactions. CCW analysis plays an important role in lending and in helping to determine the nature of the credit bargain, in particular, the amount and configuration of the loan, collateral assets, contract length, interest rate and related fees.

69. Generally, there are three main aspects to CCW analysis:

- Market information (credit databases): This consists of centralised credit data which can be categorised as positive data (financial behaviour records for the borrower, such as the total credit amount), or as negative data (records on borrower's default payments). The information on individual debtors held on credit databases is normally provided by financial institutions dealing with them. These institutions, in turn, also access such databases in making their assessments of CCW.

- Client Information: Two categories of client information are usually assessed: client personal data (basic information such as name, address, household characteristics and income), and client personal asset portfolio. Most of this information is obtained directly from the client, as a pre-requisite to credit evaluation and quotation. This information is supplemented by the credit institution's own information and analysis.

- Risk Information: Risk is generally defined as the probability of an adverse consequence. In relation to mortgage credit, it can be defined as the probability of default on a given mortgage contract. It is normally assessed by reference to historical analysis of similar cases, using data from financial institutions and/or rating/information agencies.

70. To achieve a measurable and accurate CCW evaluation, financial institutions must obtain a significant amount of information from different sources.

26 'Willingness' is used here in a technical sense to reflect the consumer's propensity to repay the loan, based inter alia on the interpretation of past behaviour, and is not intended to imply any fraudulent or bad faith motivation by consumers.

Main barriers identified

Social/Natural barriers

71. These relate mainly to domestic market characteristics and can be observed on both the supply and demand sides of the market. Financial institutions generally have a more superficial knowledge of non-domestic markets, than of domestic markets. Their awareness of procedures for documents and contract transfers in such markets is not well established. The behaviour and specific needs of non-domestic clients are often misunderstood. An accurate CCW evaluation can be affected also by language and cultural differences that alter the consumer's perception of the nature and scope of the personal information disclosure required.

Technical barriers

72. These affect financial institutions. The understanding of scoring models (including goals and capabilities), differs across institutions and Member States. At present, there are no standardised information requirements to build CCW.

Information barriers

73. These are linked to financial sector structures. They relate to the nature of national credit risk databases, in particular, the kind of model, ownership, scope and support processes. They affect the availability and comparability of the kind of centralised information required for the CCW. In a cross-border context, access to existing information on clients (potential borrowers) might be restricted or even denied to foreign lenders, hence hampering the CCW evaluation process of potential new entrants to the market.

Discussion

74. Two potential solutions to the barriers identified were examined: either adopting a common approach for credit reporting which could eventually serve as the basis for a 'European Credit Report', or facilitating the access to client information by foreign lenders through a 'European Credit Register'.

75. The European Credit Report concept concerns credit scoring. Credit scoring is a vital component of the management of risk policies by lenders. Credit scoring techniques are carefully developed and individually tailored by each credit institution. They take into account a variety of criteria including risk management, profile of the operation and profile of the client. It could be said that such diversity has the potential to offer greater choice to consumers.

76. Thus it was considered by the Forum Group that credit scoring techniques should not be harmonised to produce a European Credit Report, as it was neither necessary nor desirable to impose identical risk policies on all European lenders. Rather, credit scoring management should remain the preserve of individual lenders to handle as they wish. Furthermore, most members of the Forum Group considered that ultimately the main obstacle identified in relation to CCW, was the inadequate access by foreign lenders to the basic information that is held in national credit databases already.

77. The European Credit Register concept was considered because there are many kinds of credit registers throughout Europe. Two main criteria distinguish them: the ownership structure - public or private databases, and the type of information contained - positive or negative databases

78. Members of the Forum Group disagreed on which of these criteria to recommend as the basis for the establishment of any European Credit Register. That said, all agreed that the current situation hampered access to information by foreign lenders seeking to offer their products in a new market, hence access to national systems should be improved. Allied to this was the problem of data comparability caused by differences in terminology used, for example, differences in the definition of 'default'.

79. The general point was made that any information sharing initiatives should pay sufficient heed to data protection rules and principles. Consumer Representatives were particularly concerned that information sharing initiatives should ensure the following: that consumers gave consent to such sharing, were informed clearly of the nature of the information to be shared and the timing of this, that the information should be shared only for the purpose of assessing CCW, that consumers should retain the right to review their data at minimal charge and correct mistakes at no charge, that data controllers and processors should keep records of such data sharing and compensate consumers for any damage caused by the mishandling of such data by them.

Recommendations

22 The Commission should implement a short-term solution consisting of :

- **collecting information on existing credit databases in all Member States;**
- **promoting the development of a Memorandum of Understanding between the owners/controllers of such databases, to facilitate access to national databases by foreign lenders on the same conditions as the access offered to domestic lenders and to facilitate data comparability; and**
- **developing a project to assess the effectiveness of the Memorandum of Understanding during a pilot phase of 3-5 years.**

23 The Commission should consider how to encourage Member States to develop positive (client indebtedness) as well as negative (level of default(s)) databases, taking into account the costs and benefits of such databases.

III. PROPERTY VALUATION

80. The value of the property against which the loan is secured is another factor determining the nature of the credit bargain. As the income forecast of the client is reliable only in the short term, the valuation of the property, which is an analysis of the quality of the guarantee, is key to the assessment of risk. Thus, a pre-requisite to lending on a cross-border basis is the ability to obtain good quality and transparent valuation information about a property based in another Member State. Lenders must feel comfortable with valuations, if they are to lend cross-border.

Main barriers identified

Differing national methods

81. Because of the level of local knowledge required for an accurate property valuation, the valuer must be close to the property regardless of the location of the lender, that is, (invariably) based in the country where the property is located. Such a local valuer may be trained and perhaps even required by law, to produce a valuation using a different methodology, different standards and in a different format to the one which is required or even understood by the lender based elsewhere.

Differing national regulations

82. Where there is legislation in the lender's home country regarding valuation standards/valuation practitioners, the barriers are greater. National regulations (of the country where the property is located) prevail and are not always compatible with those of the lender and its home country. It is likely that with transactions involving two such jurisdictions, there will have to be compliance with two different sets of rules[27].

27 For example, a bank in a Member State where evaluation standards are regulated, which wishes to grant a loan in a country where valuation practitioners are regulated, must comply with its own national regulations with regard to the standards used (if the mortgage needs to be eligible for bonds or Mortgage Backed Securities). However, at the same time, it must somehow comply also with the different legal rules governing valuation practitioners in the country where the property is located.

Differing valuation standards

83. There are concerns in some countries about differing standards for valuations and valuers elsewhere. Given the importance of the property valuation in the lending decision, particularly when the property is in a country distant from that in which the lender is located, lack of trust in a valuation can be a significant barrier to entering the market.

Discussion

84. The Forum Group discussed the complexity of valuation concepts (such as market value and mortgage lending value), valuation standards (such as International, European and national standards), and national regulations..

85. It was broadly agreed that it was advisable that Member States should be allowed to retain their national standards and rules governing valuations and/or valuers. However, few members expressed concern that the continued recognition of national valuation regulations would be an obstacle to further cross-border activity. They proposed that national standards should be retained on a transitional basis only, with European or international standards prevailing in the long term. This view was rejected by the majority of the Forum Group on the basis that many local regulations in Member States are also recognised by international lenders and others (including investors, rating agencies, and supervisory authorities), as producing high quality valuations. Moreover, all Mortgage Bonds and Securities issued in the EU, are currently supported by valuations performed to local standards.

86. That said, it was considered that one way to improve levels of confidence in cross-border transactions could be through internationally agreed common standards[28] , applicable on a voluntary basis. It would be far easier for a financial institution to interpret for its national requirements a valuation prepared using international and more neutral standards, than to try to adapt a report written according to another country's national standards, particularly when such national standards might have little in common with those prevailing in the country where that institution is based. The voluntary aspect of this proposal was stressed by some to be important in ensuring that lenders retained the freedom to decide how to obtain valuations of a high standard and whether they were to be carried out internally or externally.

87. Further, it was generally agreed that greater consistency was key in the use and interpretation of valuations. For example, the European Mortgage Federation recommends that particular risk related criteria such as market risks[29] and location risks be used when preparing and interpreting valuations.

88. Consumer Representatives observed that the annual percentage rate charged on loans is related to the valuation of property, as it can be dependent on the proportion of this valuation represented by the loan. Furthermore, some lenders use the price that the property would achieve under a forced sale procedure to estimate its value. Thus they were concerned that the applicability of different valuation standards could have a detrimental effect on consumers in relation to transparency and comparability of offers.

Recommendations

24 Industry Representatives advocate that the Commission should ensure that a financial institution which lends cross-border is allowed to:

- **accept valuations prepared according to internationally recognised valuation standards of its choice, without being subject to additional national conditions; and**
- **instruct any valuation practitioner who is a member of an internationally recognised valuation body to carry out the valuation, without being subject to additional national conditions.**

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28 Internationally recognised valuation standards exist already such as :
International Valuation Standards (IVS): published by the International Valuation Standards Committee.
Red Book (Appraisal and Valuation Standards Manual): published by RICS and largely incorporating IVS.
European Valuation Standards (EVS): published by TEGoVA.

29 See Annex IV for further details.

25 Industry Representatives advocate that the Commission should ensure that a financial institution which lends cross-border, and the valuer based in the country where the property is located, are able to accept mandatory regulations for standards or practitioners prevailing in either of their respective countries (mutual recognition of regulations).

26 Consumer Representatives advocate instead that the Commission should ensure that neutral international valuation standards prevail, or that there exists a single valuation standard ensuring comparability[30].

27 The Commission should recommend that high standards of valuation be made mandatory and that all valuation reports should consider core risk related criteria such as those recommended by the European Mortgage Federation (set out in Annex IV) where applicable.

IV. CROSS-BORDER FORCED SALES PROCEDURES

89. A cross-border forced sale procedure is a statutory procedure relating to the forced sale of a mortgaged immovable property located in Member State X, to satisfy by preference a claim of a creditor located in a Member State other than X. The competent court/authority for this procedure is the one in whose jurisdiction the immovable property lies; it will in all cases apply the law of the country in which the immovable property lies (lex rei sitæ).

90. The efficiency of the forced sale procedure is essential, because it is regarded as central to the effectiveness of the mortgage collateral. The mortgage collateral, constituting the corner-stone of the mortgage lending industry, confers to the industry the security that its claims can be met. This enables the consumer to benefit from a lower interest rate as a counterpart to that security.

91. The forced sales procedure is all the more important in the (as yet) more uncertain arena of cross-border transactions, because security and certainty of the functioning of the procedure is essential to encourage such activity.

Main barriers identified

Legal

92. Forced sale procedures are different in all Member States, albeit that there are similarities in the main underlying principles. Furthermore, bankruptcy, liquidation, reorganisation and restructuring proceedings have different effects on forced sale procedures throughout the EU, for both the consumer and the lender. Hidden mortgages and preferences, amongst other factors, result in a lack of transparency and insecurity for lenders.

Systemic

93. Throughout the EU, the duration of the forced sale procedure varies from one Member State to another, as a result of factors such as over-burdened judicial systems, litigation traditions and the length of deadlines provided for by law.

94. A related systemic barrier is the variation in the cost of the procedure between Member States. The duration of the forced sales procedure, in particular, can have a direct effect on the cost. The general duration can vary widely from 2-3 months to 5-7 years. In addition, a foreign lender who grants a loan secured by a mortgage in another Member State, may have to deal with another legal system and often with a foreign language. As such, it has either to acquire a substantial knowledge of another legal system and another language, or call in experts in that Member State. Both of these scenarios translate into extra cost.

30 This Recommendation only emerged at the end of the Forum Group process on the basis of information gathered by the Consumer Representatives and was added at the latters' request. It was therefore not subject to the same level of prior assessment and collective discussions as the other Recommendations contained in this Report. It merits further discussion.

Discussion

95. It was considered that lenders are well accustomed to dealing with the law of lex rei sitæ, that attempting to penetrate a foreign market is a business decision, and there are many ways of achieving this aim including cross-border lending or through some sort of establishment in the foreign market. Problems for cross-border mortgage lenders in the field of enforcement are similar if not often the same as those encountered by domestic lenders.

96. It was stressed that the enforcement of the mortgage collateral is perceived to be the worst case scenario. In practice, before resorting to enforcement, lenders can and do adopt a wide range of measures aimed at helping the borrower experiencing financial difficulties.

97. Two possible courses of action were considered: harmonisation of forced sales procedures and improvement of national systems.

98. Possible harmonisation of forced sales procedures would have to tackle many areas of substantive civil law and procedure, including housing and tax law. This was considered to be an immense task, due to the variety of legal systems and traditions involved. Furthermore, to the extent that a mortgage loan is a contract, it could be preferable to integrate consideration of it into the framework of the Commission's Contract Law Action Plan, and not to recommend action prematurely and independently of that process. In any event, such harmonisation could not address the problems stemming from the factual status quo diverging from one Member State to another, including factors such as over-loaded courts and the relative levels of litigation activity.

99. The policy objective as regards improvement of national systems would be to encourage the development of efficient, cost-effective, and simple enforcement procedures, which would confer security to the mortgage collateral and might enable the lender to grant and the borrower to obtain cheaper credit.

100. This could be achieved by measuring the performance of different legal systems, in order to identify and promote the wider adoption of their positive features.

101. For such measurement, the Forum Group identified the following two objective criteria: duration and cost. For duration, the Forum Group considered that evaluation should focus on identifying the total average/minimum/maximum duration of an enforcement procedure from the preliminary stage until payment, firstly where no legal remedies are exercised by the debtor and secondly where the debtor exhausts all available legal remedies. For cost, it considered that evaluation should focus on identifying the total average/minimum/maximum cost of an enforcement procedure for the satisfaction of an initial claim of 100.000 euros, again firstly where no legal remedies are exercised by the debtor and secondly where the debtor exhausts all available legal remedies.

102. Leading on from this, it was proposed that the reasons for lengthy procedures and costs which are higher than the EU average, be investigated, in order to promote reductions. This goal was supported by all, albeit that some questioned the extent to which it was feasible for the Commission to ensure such reductions, especially in duration, given the complexity of the legal traditions and procedures involved.

Recommendations

28 The Commission should first:

- **Perform an evaluation exercise of forced sales procedures within one year.**

- **Thereafter, monitor the functioning of forced sales procedures and assess results every three years. These results should be presented in the form of an official EU scoreboard on duration and cost of forced sale procedures in every Member State and lead to Commission advice/action for improvements.**

29 Thereafter, if necessary, the Commission should promote measures to ensure that the duration of a forced sale procedure should not exceed a specified term, for example two years after the first step in the forced sale procedure.

CHAPTER 3: COLLATERAL ISSUES

I. REGISTRATION

103. Most real estate charges are submitted for registration in Member States. Registration systems vary significantly and range from informal (and unsecured) registration to high security systems. Furthermore, the apparent security given to lenders by registration may, to an extent, be illusory. This is because a broad range of private or public overriding interests can interfere with the legal value of the registered rights.

Main barriers identified

Transparency of information

104. National Registers are not always as readily accessible and comprehensive as they could be, albeit that there are initiatives underway to address this, such as EULIS[31].

Hidden Overriding Interests

105. Member States have differing registration requirements for overriding interests. Such differences can reduce the level of legal certainty and interfere with real estate charges, which are subject to the same registration system. These overriding interests may be created by a private individual or by a public authority, and cause a change in the value of the real estate charge securing a loan. This is, of course, an obstacle for the national market, but it represents also a significant barrier for external access to the market and cross-border lending.

Duration of mortgage enrolment

106. Under some legislation, for example in France, the duration of a mortgage is limited. For both the customer and the bank, the mortgage is a legal instrument to secure a loan. It should, therefore, have a lifespan of at least until the point at which the loan matures.

Difficulties with accessing registration systems

107. At present, in order to access national registration systems, foreign market participants use the freedom of establishment mechanism to operate abroad, which leads to higher market access costs.

Discussion

108. The Forum Group did not consider that different registration procedures or security standards were themselves a barrier. Rather, the problem appeared to lie in the insufficient centralisation of the information, necessary to enable a foreign market partner to have equal access to the mortgage credit market.

31 In the EULIS initiative, official land registration organisations from 8 European countries are cooperating to develop a pan-European land information service. See Annex V for further details.

Recommendations

30 The Commission should ensure that:

- **all charges affecting real estate must be registered in a Public Register in order to be binding on and take effect against third parties, regardless of their nature;**
- **the creation, modification or extinction of a charge on real property[32] shall become effective vis-à-vis third parties only at the point of registration in the Public Register; and**
- **registered charges on real property in relation to the same estate shall rank in the order of priority disclosed in the Public Register.**

31 For filings of applications for registration[33] /notification[34], the Commission should allow Member States to decide that priority be determined according to the time at which the application was received (not actual registration). In this scenario, the Member State should ensure that filings of applications must be registered or rejected by the Public Register in the order of receipt.

32 The Commission should ensure that Public Registers make all relevant information available to all parties or their representatives.

33 The Commission should ensure that Member States provide that the responsible Public Register certifying authority should have state indemnity. In the event that such responsibility is delegated to a third party, such party shall be covered by appropriate professional liability insurance for an adequate sum.

34 The Commission should ensure that Member States do not maintain or institute additional 'legalisation'/'validation' requirements, for authentic instruments formally drawn up in other Member States.

35 More generally, the Commission should provide financial support to the EULIS initiative, to enable and encourage its expansion across the EU.

II. TRANSFERS OF MORTGAGES BETWEEN LENDERS

109. It was considered that cross-border lending could be much more efficient if lenders could trade mortgage loans and mortgage securities freely. This could occur in the context of remortgaging, transfer of mortgage portfolios and dealing in mortgage backed securities (MBS).

Main barriers identified

'Accessoriness': the linkage between the debt and the collateral security

110. In the majority of legal systems in Europe, the link between the principal debt and the collateral is very strictly enforced. Any changes to one have a significant effect on the other. Such a strong link between the loan agreement and the security agreement (i.e. strong accessoriness), does not facilitate changes to either. The result is inflexibility, constituting limited economic freedom for the private customer, as well as an obstacle for lenders. Accessoriness can arise in many ways and to differing extents. It can inhibit the use of mechanisms for refinancing or balancing risk management.

32 Charge on real property in the sense of this Recommendation means the right to extract from the estate the defined and registered amount.

33 Enrolment with consent of the owner.

34 Enrolment without consent of the owner.

Variety of mortgage deeds

111. There are a wide variety of mortgage deeds in use across Member States. Some are in a standard form issued by civil law notaries or the Public Register, while in other Member States such as the UK, mortgage lenders use their own form of mortgage deed. This variety can hinder transferability of mortgages.

Lack of ability to pool debts

112. Some legal systems allow pooling of securities, where the banks participating in a single loan can step in or out without affecting the loan and / or the securities. The English security trust and the German Grundschuld are the best examples of this. The non-availability of this mechanism constitutes a barrier to more efficient (re)financing.

Lack of Cross–Collateralisation

113. While it would be possible to encumber more than one property in the same country with a facilitating mechanism such as a Euromortgage (see discussion section below), problems occur when the properties are located in different countries, because of variations in the different national jurisdictions.

Costs caused by transfers of mortgages

114. Whenever parties to a secured loan wish to change the arrangements, this causes inconvenience, since each change must be evidenced by the lender to the registration authority. This adds to the cost of such transactions.

Discussion

115. It was recognised during the discussion that some Member States may prefer not to introduce a flexible link between the credit agreement and the collateral security. However, there are already systems in place in some countries such as Sweden, which provide good examples of how a lower accessoriness can work well in practice[35].

116. The Forum Group discussed other ways to facilitate transfers of mortgages, focussing on the Euromortgage and the European Security Trust.

117. The Forum Group considered the Euromortgage to be an alternative tool which could be introduced by Member States, without substantial changes to their existing legal systems, as it would operate under the rule of lex rei sitae. Such a pan-European non-accessory mortgage instrument could:

- avoid burdensome and costly inquiries in other Member States concerning local regulations and the quality of the national mortgage instrument;
- reduce additional and differing formalities and authentication;
- offer mortgage collateral as security for more than one mortgage credit;
- enable easy transfer of the mortgage as well as the property;
- meet the requirements for cross-collateralisation on a cross-border basis;
- meet the requirements for securitisation and mortgage portfolio management; and
- enable the creation of bank syndicates for mortgage finance.

35 Due to the flexible Swedish legal environment and well-established practice, there is no need for a third party representative. There, the loan document is not submitted for registration. Instead the landowner asks the land registration authority to register a deed over his real property for a particular amount. He then receives a Mortgage Certificate ('MC'). The MC can be handed to a lender as security for a loan, if in paper form. If the MC is in register form, it is transferred to a lender's MC account with the register authority. Alternatively, it is transferred automatically when the lender applies for an MC (or, in case of changes of lender, from the lending bank to the releasing bank). No intermediaries are involved in this process.

118. The Forum Group considered that the European Security Trust mechanism should also be encouraged. The European Security Trust would allow a single bank to hold mortgage collateral on trust for all the banks participating in the credit agreement. The position of the consumer would remain unchanged. The security position of the bank participating in the trust and holding tranches of the loan would be protected from the insolvency of the trustee bank, since the trust would be separate from the other assets of the trustee. Only those bodies determined to be suitable by national law (and holding appropriate indemnity cover) could act as trustees. Banks could step in and out of the structure, participating according to their refinancing levels in relation to their rating and to their willingness to take a certain risk or tranche of loans. This would mirror the situation in capital markets.

Recommendations

36 The Commission should ensure that links between mortgage debts and the collateral security are made more flexible. In countries where there is an existing requirement for strong accessoriness between the loan and the collateral, this should be replaced by an accessoriness agreement in the form of a private agreement between the lender and the owner of the mortgaged property. The relationship between the loan and the collateral can be dealt with in such a way as to allow it to be tailored to fit the needs of the parties[36].

37 The Commission should ensure that Member States allow the lender or any beneficiary of a charge on real property, to appoint a representative (Mortgage Register Representative[37]) vis-à-vis the Public Register. His/her position should be disclosed on the Register and not have any effect on the legal framework of the Register. He/she should be entitled:

- **to establish any abstract of title;**
- **to consent to a change in the respective ranking of charges over the real estate in question and to grant preferential rights between beneficiaries as shall be deemed appropriate;**
- **to consent to, apply and file any registrations and notifications;**
- **to consent to any change or transfer of the charge on behalf of (and in the name of) the owner of the charge; and**
- **to act on behalf of the owner of the charge in relation to the discharge or cancellation of the charge.**

38 The Commission should explore the concept of the Euromortgage[38] , for example by way of a study, to assess its potential to promote EU mortgage credit markets integration

39 The Commission should encourage Member States to increase the transferability of mortgages by introducing pan-European Security Trust instruments.

36 Any change in the collateral (e.g. sale of property and purchase of a new one), should be possible without fundamentally changing the security package. Equally, more than one property could be used to secure the amount borrowed. All this should be possible without weakening any links between the debt and the collateral.

37 Changes of mortgage creditors carried out by the register representative without simultaneous registration in the Register will not materially affect third parties' interests, because the Register will still show the overall size of all enrolled rights. Changes within the limit of the registered charges do not alter the published content or interfere with protected interests, but represent simply another allocation of pre-existing claims. As the register representative's action may not lead to a material discrepancy between published and de jure existing liens, transparency with respect to size and content of all registered charges will continue to be safeguarded.

38 See Annex VI for further details.

CHAPTER 4: DISTRIBUTION ISSUES

I. CROSS BORDER DISTRIBUTION

119. There are many ways in which lenders can distribute products across borders. The most common occurrence at this point in time, is where the borrower is located in a different Member State to the one in which both the property and the lender are located, or where the property is located in a different Member State to the one in which both the borrower and the lender are located. The next stage of development in such a market and the one generally contemplated in this Report, is where the property and the borrower are located in one Member State, and the lender in another. A final scenario where all three, the property, borrower and lender, are based in different Member States, is considered possible but unrealistic at this stage of development of this market and for the foreseeable future.

120. Lenders can access consumers in different ways to facilitate cross-border distribution, such as through representative offices/branches/joint ventures or through the use of distance sales mechanisms like the telephone/Internet. That said, there are limited examples of true cross-border activities.

121. But all these experiences are on a niche basis. They occur mainly in regions bordering national boundaries or in neighbouring markets (or other proximate markets such as those which are a popular choice for holiday homes), which offer the advantages of a common language and familiarity with market conditions, amongst other favourable factors. The Forum Group has not been able to identify a successful experience of cross-border distribution on a mass market basis.

Main barriers identified

Economic

122. Mature market: Some argue there does not appear to be a business case for cross-border sales on a mass market basis, because there is a lack of consumer and lender interest and it is not clear that the offer of products on such a basis will be taken up. One of the key elements to consider in this respect is that in mature markets, the mortgage credit is usually cross-sold with other products, not least because stand-alone products offer limited returns. This makes it more difficult for the consumer to compare different loan offers on a like for like basis, which raises also the issue of consumer protection. Nevertheless, in some countries specialised mortgage banks offer only mortgage credits, sometimes due to a prohibition on selling it together with other products. In general, however, the profit margin on stand-alone mortgages is low. If bundled (i.e. combination) products are the focus and not simply the mortgage credit, then it is the whole retail banking operation that has to be addressed. Major differentiation between the local product(s) and those from another Member State, for example, through more competitive interest rates or general product innovation, is necessary for such cross-border activity to be successful.

123. Emerging market: Entry to the EU of the new Member States has begun the process of the opening-up of such markets to lenders across borders. A mass market is possible here, but largely untested so far.

Legal

124. In brief, there are difficulties for lenders seeking to operate across borders, caused by the existence of and lack of familiarity with different local rules. This is explored in more detail elsewhere in this Report, in particular in the chapters on Legal Issues and Consumer Confidence.

Discussion

125. The 'local nature' of a mortgage credit was highlighted, in comparison with other retail financial services products such as savings and current accounts. This was regarded as likely to make it more difficult to create a single market for mortgages, compared to one for other financial products and services

126. Consumer protection and confidence, discussed in depth elsewhere in this Report, were agreed to be an important factors when assessing the issue of cross-border distribution.

127. In addition, the importance of a low interest rate, competitive with that offered by local banks, was underlined. That said, there was undoubtedly the potential for innovation in cross-border distribution in other ways including the following examples: high loan-to-value products, long term fixed rate mortgages, home loans without a mortgage[39], refinancing and equity release markets, sub-prime markets and Islamic loans. A view was expressed within the Forum Group that any future legislation should not standardise products and services, in a way which could hinder product innovation. Financial institutions should be free to design banking products in response to customer needs and to reflect the economic realities of the market.

Recommendations

40 The Commission should assess and ensure equal treatment of local banks and foreign banks on the basis of the same business, same risks, same rules principle.

II. BRANCHES

128. Branches are the major distribution channel for mortgage credits. They proliferate at different levels throughout the EU: there is an average of 547 branches per 100 000 inhabitants (Source Eurostat) with a minimum of UK 261, Sweden 242, Greece 233 and a maximum of Spain 1000 and Germany 751. Local offices respond to the need for proximity and face to face dealings with customers embarking on one of the most important financial transactions of their lives. They offer reassurance, in particular in relation to after-sales service.

129. Usually branches do not have a separate legal personality, because they remain attached to their 'parent' undertaking. On a supervisory level, branches have to comply with some reporting requirements in the host Member States, in addition to the reporting requirements they have to fulfil in their home country.

130. They also have to comply with national consumer protection laws where applicable, without prejudice to compliance with relevant EU laws.

131. In some countries specialised branches exist including "All under one roof" in Germany and mortgage shops in the UK. In others, branches operate through a joint venture with insurers or, as in the UK, large retailers such as supermarkets. These retailers sell mortgages from their existing distribution networks. Postal banks may also play an increasing role.

.Main barriers identified

Economic

132. Mature market: a mass market approach needs the sale of bundled products to be profitable, due to the cost of entering the market with local offices and the likely low or non-return on investment in a branch network. On a niche approach, a joint venture is likely to be necessary. At first glance, the appetite for such partnerships seems relatively limited.

39 Such loans are common in France, apparently constituting almost 50% of all new home loans there in 2002. A collateral from another credit institution or insurer takes the place of the mortgage, thus avoiding mortgage registration costs and procedures.

133. New / emerging market: The time and cost of entering the market may be significant, but the rewards are potentially higher, if competition in the local market is more limited.

Cultural

134. In brief, willingness to enter into relationships with foreign lenders may vary.

Discussion

135. It was considered that local branches were an extremely important mechanism to establish consumer confidence, a concern covered in detail in Chapter 1. A non-domestic brand would have to counterbalance any negative perception of its 'foreign' origin, by ensuring close proximity to the consumer. Having a local office is a vital way to do this, but of itself is not enough to ensure market share. A competitive interest rate and/or product innovation would be required as well. The various costs of establishing a branch network are high and the return on investment a long-term prospect.

136. It was considered by some Industry members of the Forum Group that in order for cross-border lending to provide added value and contribute to product variety, it was important to ensure that products offered in this way did not become 'local', by being obliged to meet the product requirements of the host market

137. Representative offices were highlighted during this discussion, Representative offices are considered to be the natural first step for lenders contemplating embarking upon cross-border lending activities and indeed can support such activities. A representative office offers consumers a local contact point for information. The lender creates a local presence, without establishing a more costly branch or subsidiary. Such activity is subject to much less regulation than branches or subsidiaries. EU legislation in this area covers cross-border services and branch establishment, but not representative offices. Since Member State legislation in this area differs, the process of opening a representative office can, in some cases, be more difficult and time-consuming than establishing branches.

Recommendations

41 The Commission should revise the legislation covering cross-border services and establishment of branches to include the establishment of representative offices, in order to ensure that there are no disproportionate barriers to the establishment of such offices.

III. INTERMEDIARIES

138. The role, importance and activities of introducers of mortgage business vary significantly between Member States.

139. The draft definition in the version of the proposed Commission Consumer Credit Directive prevailing at the time of the Forum Group's deliberations provides that: "credit intermediary means any natural or legal person, who, for a fee, (principally) acts as an intermediary by presenting or offering credit agreements, undertaking other preparatory work for such agreements, or concluding such agreements; the fee may take the form of cash or any other agreed form of financial consideration."

140. Three broad types of intermediaries were identified by the Forum Group:

1 **"Simple intermediaries"**: They establish the contact between the lender and the consumer. They provide information or advice depending on the Member State, make contact with the lender on behalf of the consumer and are involved in the pre-sales process only.

2 **"Independent agent"**: They act for the consumer and are the contact point with the lender, preparing the application and arranging its conclusion.

3 "Tied agents": They represent and act for the mortgage provider. They can be freelance or an employee of the mortgage loan provider. The mortgage loan provider is responsible for their actions, assuming full responsibility for the sale of the loan.

141. As can be seen, intermediaries can be specialised (for example mortgage brokers and mortgage agents), or engage in such activity as an adjunct to their main profession (real estate agents, financial advisers and developers). They are regulated in many ways including specific mortgage legislation, regulation of their main businesses and general regulation of small businesses. As a result, understanding how intermediaries operate and what rules they have to observe in national markets, is quite complex.

142. Intermediaries are paid by fee or commission. They are usually paid by the lender, but in some cases the borrower may be charged as well. Varying rules exist on the transparency, level and pre-conditions for any commission.

Main barriers identified

Economic

143. Intermediaries are not present in all Member States to the same extent and are minimally represented or not present at all in Greece, Sweden, Finland.

Legal

144. Regulatory frameworks differ and there is an associated difficulty of lack of knowledge about them. In addition, there is concern, from a consumer perspective, about lack of transparency about commission payments.

Discussion

145. Consumer Representatives in the Forum Group pointed to the need to foster consumers' trust and confidence, matters covered in more detail in Chapter 1 and its Recommendations, which were relevant in this context as well. They considered that the demands and needs of the consumer and the underlying reason for any advice given should be specified (on a durable medium), so as to ensure proper provision of information to the consumer. Also, the advice given should follow the principle of 'best advice possible'. It should be compulsory for the intermediary to search for the credit best adapted to the consumer's needs. Industry Representatives were opposed to making the provision of advice compulsory, and to the recommended standard for any such advice that was given to be that of 'best advice'.

146. In addition, the Consumer Representatives considered that there should be complete transparency as regards the commission received by the intermediary. Intermediaries should inform consumers about all the commissions/fees they receive from selling the different products they propose, regardless of source or description. Industry Representatives did not agree on the extent to which transparency was necessary indicating, for example, that commissions payable by lender to intermediary need not be disclosed to the consumer.

Recommendations

42 The Commission should introduce a supervisory system for independent intermediaries along the following principles: registration with a competent authority in the home Member State; possession of appropriate professional knowledge and ability (to be determined by home Member State including requirement that the intermediary to be 'fit and proper'); possession of professional indemnity insurance and a complaint/redress scheme in line with requirements for other intermediaries to ensure consistency. In addition, Consumer Representatives advocated that under such a system there should be declaration at the outset of the relationship between consumer and intermediary of all payments including every commission/fee, and that records should be kept of any information/advice given to consumers. In the context of this Recommendation, Consumer Representatives pointed to the need to consider their Recommendation 9, in particular, with its reference to a 'best advice' standard.

IV. INTERNET

147. The Internet is considered to have limited potential as a distribution channel at this point in time. Only standardised products can be offered and not all contracts can be concluded on-line, albeit that this situation is likely to change as a result of EU legislation. Most importantly, currently there does not appear to be consumer demand for 100 % completion on the Internet. In the future, webcam operation may increase consumer appetite for on-line processes.

148. At the same time, there is continuing development of the Internet as a pre-sale information source. In association with telephones services, the Internet is becoming a tool used by an ever-growing number of people. The Internet has also enlarged competition by making easy comparison possible through its offer of free access to information and provided new opportunities such as those for on-line brokerage.

Main barriers identified

Factual

149. The Internet is used for pre-sales facilitation only in most countries. The potential customer/lender will desire face-to-face contact at some stage, before entry into a legally binding relationship.

Legal

150. There are differences in the capacity to complete legally binding agreements on-line caused, for example, by the requirements of money laundering legislation. Related to this, there are differences in processes within Member States, which inhibit practically the ability to conclude such agreements on-line. In addition, there is possible uncertainty as to the applicable consumer law, levels of protection, and rights of redress where applicable (including access to a dispute resolution service).

Language

151. Not all providers of financial services offer access to their websites in different languages or via national domain names.

Discussion

152. The use of the Internet is evolving rapidly. Attitudes, regulation and technology may change the role of Internet in the near future. In association with telephone services, the Internet may become an established distance distribution channel for mortgage credits in the future. Denmark and Sweden are examples of an almost 100 % Internet based sale process. However, these examples are limited to loan refinancing, where the advice element is minimal. Thus, these examples were not viewed as the start of a general trend in the short to medium term. In addition, Consumer Representatives expressed concern that from the consumer perspective, the Internet might not always be an appropriate medium for conclusion of contracts of such complexity and importance.

Recommendations

43 The Commission should review what mortgage transaction actions require written processes and/or a physical presence generally and review money laundering legislation in particular, to address current legal barriers to greater Internet use

44 The Commission should ensure consistency, especially in relation to information requirements, between different directives affecting financial services products

CHAPTER 5: FINANCE

I. FUNDING

153. Faced with increasing margin and cost pressure, European mortgage lenders have been exploring ways to innovate in order to increase market share and profitability, reduce the overall risk exposure and increase performance and effectiveness. Innovation is particularly visible at product level, but also apparent in relation to funding tools, as lenders develop sophisticated housing finance techniques aimed primarily at tapping the European and international capital markets.

154. Housing finance has traditionally been based on short-term retail deposits. These are, on the face of it, a cheap form of funding. But they may also be indirectly cost-consuming, as they rely heavily on large branch networks. In addition, deposit funding makes long-term fixed interest rate mortgage loans more difficult to offer, as lenders may face financial difficulties resulting from a mismatch of short-term deposits with long-term assets. Over the last few years, most countries have been experiencing a decline in deposits, as customers look for alternative and more lucrative ways to invest their savings. Consequently, lenders have increasingly looked to the capital markets to finance their mortgage lending activities and possibly obtain capital relief by selling off their loan portfolios. The development of better mortgage funding instruments would provide an alternative to retail deposits and give lenders access to the capital markets and thus cheaper funding. Thus in recent years, mortgage funding via the capital markets has grown significantly, as more lenders seek to attract international capital and secure a more broad-based and stable investor composition. Cheaper access to capital could also be achieved by using funding instruments such as covered bonds, issued directly from mortgage banks, without unbundling the process. The Mercer Oliver Wyman study[40] provides a good example of this with its description of the Danish and German markets for housing finance, countries with the lowest prices and also a high degree of funding based on liquid bond issues. By issuing bonds of the identical nominal value, interest rate, currency and repayment profile as the loans which the bonds are issued to fund, it is possible to dramatically reduce financial risk.

155. In this overall context, when assessing the financing aspect of the further integration of the EU mortgage credit market, the Forum Group has:

- explored the possibility of enhancing market integration through the development of a liquid and dynamic secondary market in Europe. The Forum Group looked at ways of establishing a stronger link between mortgage lending and funding in the capital markets. To this end, members addressed two main issues: firstly, the development of a loans secondary market and secondly, the development of mortgage funding instruments.

- attempted to identify market and regulatory barriers preventing lenders from effectively using existing mortgage funding mechanisms. To a large extent, the analysis and the recommendations made in previous chapters of this Report also have implications for the Forum Group's discussions on the funding aspects of the integration of the EU mortgage credit markets.

II. THE DEVELOPMENT OF A LOANS SECONDARY MARKET

156. Efficient and dynamic loan portfolio management is inextricably linked to the development of a secondary market in loan claims and the techniques of structured finance, such as securitisation and credit derivatives. In advanced financial systems, these three mechanisms (loan sales, securitisation and credit derivatives) are used simultaneously. They are complementary, with each instrument able to meet the special needs of particular transactions and particular types of intermediary.

40 See Footnote 9.

157. However, for smaller lenders, loan sales are probably the only really accessible way of managing their portfolios, as the other two techniques depend significantly on economies of scale. More specifically, the real development of portfolio management, especially in banking systems where credit origination is fragmented (such as in Italy/ France/Spain), depends on the emergence of an efficient secondary loan market. This creates the conditions for pooling, by specialised intermediaries, of several loan portfolios from various originators.

158. A liquid secondary market is an invaluable benchmark for pricing loans during their origination (for loans with features similar to listed ones) and a valuable source of information for statistical/mathematical models of credit risk management based on market values. At present, as the best available substitute, these models use data drawn from the corporate bond market.

159. A further aspect of the importance of secondary loan markets relates to their relevance to a common phenomenon in the more advanced financial systems, namely the unbundling of the value chain and the specialisation of institutions in individual phases of the credit process (loan origination, underwriting, funding, servicing, risk processing). The creation of the secondary market is the necessary link between these various actors; the element enabling each to perform its own functional role more efficiently within the overall credit activity, eventually linking consumer borrower to investor

160. An indirect effect of the presence of a secondary market is that it leads to a standardisation of loan products according to the features that make them eligible for trading on the market. In general, the presence in various forms of a secondary loan market, provides system-wide economic benefits enjoyed by both the originators of loan assets (large and small alike), and by the investment banks (domestic and international) that act as purchasers and intermediaries of wholesale credit risk. The originators gain improved access to the capital market, while buyers are exposed to a larger pool of loans than would be the case in the absence of the secondary market. The ultimate result of this greater value chain efficiency can be passed on to the final consumer (the borrower), in the form of lower interest rates and a wider range of mortgage loan products.

161. Market experience shows that a number of EU countries have recognised the merits of multi-origination platforms. However, although most of these facilities have resulted in national success stories, the European market has failed to develop an appropriate pan-European model for an integrated EU secondary market.

162. Internationally, the best known example of a secondary loan market, (limited to mortgage loans and solely for securitisation), is in the US.

III. MORTGAGE FUNDING INSTRUMENTS

163. The use of retail deposits is currently the most widespread and the most traditional form of funding mortgage loans, but there are trends towards capital market funding. However, due to interest rates being at an all-time low, customers look for more profitable ways to place savings. Therefore, deposits need to be supplemented by alternative methods of funding.

Existing models and funding techniques

164. Mortgage lenders in the EU use a variety of methods to fund residential mortgage loans. The method used in any given transaction depends on a large number of factors, including the type of mortgage lender (universal bank, savings or cooperative bank, specialised mortgage lender, insurance undertaking and so on), the way the capital is used and the legal and fiscal frameworks.

165. **Retail deposits** currently make up c. 60%[41] of mortgage funding, although this level is decreasing. The use of savings deposits (sight and term deposits) to finance mortgage loans is the most widespread method in the EU, existing in virtually all Member States. The system is dominant in Belgium, Finland and Austria, where savings deposits represent the largest source of mortgage refinancing. Savings deposits are used by a variety of mortgage lenders, including commercial/universal banks, savings banks and mutual & co-operative banks. Savings deposits are also used in the so-called 'contractual savings system'. Under this system, potential house buyers agree to save a certain amount for a certain period, usually below market rates. Once the saving period expires, the borrower qualifies for a loan, also at below market rates. This system is mainly operated in Germany and Austria (and increasingly in the new EU countries) by the so-called 'Bausparkassen'. The use of deposits generally (both savings and accounts), is also dominant in France, Greece, Ireland, Spain and the Netherlands.

166. **Covered bonds**[42] While the nature of covered bonds and the preferential claim they contain can vary, certain safety aspects such as asset eligibility and coverage, bankruptcy remoteness and regulation, have become common in most European jurisdictions. They enable high ratings and make European covered bonds a viable investment alternative to European governments, agencies and supranational bonds. At the end of 2002, the European Mortgage Federation reported that mortgage bonds outstanding amounted to about €588.8 billion[43]. Covered bonds roughly represent 17% of the EU bond market.

167. The dramatic growth of the mortgage bonds market has coincided with increased investors' appetite for new mortgage bond formats. One important trend in this context has been that most EU countries by now have implemented legislation on covered bonds and/or Residential Mortgage Backed Securities (see below)[44]. The best known success stories are the German Jumbo Pfandbriefe, Danish Realkreditobligationer, Spanish Cédulas and French Obligations Foncières, to name but a few.

168. **Residential Mortgage Backed Securities (RMBS)**[45] are issued in a number of European countries to fund mortgage loans. RMBS constitute a popular method used to remove assets from the bank's balance sheet, in order to reduce the amount of regulatory capital which has to be retained. While covered bonds are mainly used as a funding tool, recourse to securitisation is rather part of the lending institution's credit risk management policy

169. The total volume of RMBS issuance in Europe in 2003 amounted to €110bn[46] . The main issuers of RMBS are the UK, Netherlands, Spain, Italy and Germany, with the UK dominating the market (currently c. 50% of all RMBS issuance). However, with the appearance on the market of 'structured' covered bonds, some issuers are starting to shift away from RMBS and towards covered bonds as an alternative source of funding.

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41 'Funding of Mortgage Loans in the European Union and Norway'. European Mortgage Federation (2002).

42 Covered bonds can be defined as full recourse debt instruments secured against a pool of mortgage assets and/or public sector claims, to which investors have preferential claim in the event of bankruptcy of the issuing institution. With covered bonds, loans that comply with the requirements set by law are pooled together and funded through the issuance of secured bonds on an 'on-balance process'. Covered bonds are covered by mortgage loans and collateralised by property (i.e. mortgage bonds). In some cases they are covered by public sector loans.

43 'Mortgage Banks and the Mortgage Bond in Europe'. European Mortgage Federation Fourth Edition (November 2003), p11. The whole European covered bond market amounts to €1.5 TN, which includes bonds secured on mortgage as well as public loans.

44 18 countries in the European Union have now introduced legislation on covered bonds. See Annex VII for further details.

45 Under this system, the credit institution creates a legal entity known as Special Purpose Vehicle (SPV) and sells mortgage loans that it has originated. The SPV isolates the receivables and the associated cashflow from the originator and performs other closely related operations, such as restructuring of cashflow and credit enhancement. The SPV then issues the securities which are sold to investors. Following the type of mortgage assets, residential or commercial, these securities are called residential (RMBS) or commercial (CMBS) mortgage-backed securities.

46 The total volume of outstanding MBS in Europe amounted to €123bn (of which €13bn were CMBS). European Securitisation Data Report Winter 2004. European Securitisation Forum.

New types of funding models

170. **Structured covered bonds** are a new type of covered bond being introduced into the European market-place. They could be defined[47] as (i) a covered bond where securitisation techniques are used to enhance the rating of covered bonds, or (ii) a secured bond issued against a pool of assets in a jurisdiction where no specific covered bond law has been established. In 2003, structured covered bonds[48] were issued for the first time in the UK, in the context of the absence of a specific regulatory framework. .

171. **Multi-origination platforms**[49] are not new in the European mortgage markets. For some years now, facilities like the French CRH (Caisse de Refinancement de l'Habitat), the Spanish AyT (Ahorro y Titulización) and mortgage banks such as Danish Totalkredit, and more recently the Italian Credit Circle, have been used by lenders as funding vehicles for entry into the secondary market. Although these facilities were created at different times and for different reasons, they all respond to a common need, that is, to reduce mortgage funding costs by exploiting the opportunities offered by the capital market.

172. The existing multi-origination facilities mentioned above have certainly achieved their objectives and provided national mortgage lenders with an alternative and efficient way to finance mortgage lending activities.

173. In addition to such existing platforms, the idea of a European Mortgage Finance Agency (EMFA)[50], modelled on the examples of the US Government Sponsored Enterprises Freddie Mac and Fannie Mae, has been proposed as one way of replacing what EMFA considers to be a fragmented European MBS market with a more standardised pan-European one.

Main Barriers Identified

Transferability of assets and multi-origination pooling

174. There exist a series of impediments to loan transfers between mortgage lenders from different countries. This results in additional burdens and costs that might ultimately deter lending institutions from selling their mortgage portfolios to third parties. If loans are not transferable, it is virtually impossible to create pan-European loan portfolios for single lenders/issuers, or to create pan-European multi-originator funding platforms for small and medium sized lenders.

175. In addition, the transferability of certain assets in case of the bankruptcy of the lending institution may become difficult in cross-border lending activities if, for instance, mortgages are registered in a foreign register from which they can be removed under specific circumstances. This is why, increasingly, legislation allows lenders to use MBS in their segregated covered bond pools, since they are easily transferable. Most legislation does, however, limit the percentage of MBS that can make up a pool.

176. Finally, from a slightly different perspective, national provisions forbidding lenders to use foreign loan portfolios also impede multi-origination pooling. The internationalisation of the markets has increasingly led to the inclusion of foreign assets into segregated pools, although the mortgages are registered abroad. But in some Member States, there are legal barriers to this.

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47 See Annex VII for further details.

48 In July 2003, HBOS Plc, the UK's largest mortgage lender, announced its plans to sell the first so-called covered bonds by a British lender. Other UK mortgage lenders seem willing to follow the HBOS example.

49 See Annex VII for further details.

50 For more information on the EMFA project, see Annex VII.

Segregation of assets

177. The main reasons for using mortgage bonds are access to cheaper capital funding and risk management. In this context, the rating agencies play an important role. They focus on multiple criteria when appraising credit institutions including legal criteria, the economic situation and the management of the credit institution. The legal criteria are the most important. One of the main issues rating agencies deal with, relates to the segregation of the cover pool. This is of fundamental importance in case the issuing institution goes bankrupt, as rules on the segregation of the cover pool directly affect timely payment of principal and due interests to bond holders. Therefore, in order to guarantee the quality of the security and attract a high rating (i.e. AAA), it is of paramount importance that the national legislation contains provisions allowing for timely payments of capital and interests. To this end, a high level of legal certainty is needed. Although a number of Member States have introduced legislation in this respect, in practice timely payments may be put at risk in some jurisdictions by a number of procedures such as the nomination of a trustee and economic and financial audit.

178. At present, not all legislation allows for the clear segregation of the cover assets (for example, not in Spain, Austria and the Czech Republic) and the issue can become more complicated in multi-origination deals. In securitisation transactions, in order to de-couple credit risk on the assets from credit risk on the originator, it is crucial that the securitisation vehicle is not considered to be part of the originator, should the latter become insolvent or bankrupt.

Taxation issues

179. The progressive integration of economies has not yet reached the tax systems across the EU to any large extent. This explains the huge differences in concepts, values and subsidies encountered. The purchase of a house, the closing of a loan contract, the constitution and registration of a mortgage and the foreclosure procedure are all submitted to taxes, which differ widely between Member States. Often this will result in double or triple taxation, if more than one Member State is involved in a transaction. For example, if a borrower resident in one Member State takes out a mortgage in another, the collateral may be taxed in one country and the loan contract in the other. This, in effect, results in double taxation, because both countries can levy all taxes in connection with both the loan and the mortgage on one of the contracts.

Barriers Discussed Elsewhere

180. Also of relevance in this context, are barriers discussed elsewhere in this Report, primarily different consumer protection rules, difficulties with foreign distribution networks and land registration systems[51]. It should be reiterated that Consumer Representatives do not agree with this categorisation of differences in consumer protection rules as a 'barrier', considering instead that such rules simply reflect the characteristics of different national markets.

Discussion

181. Securitisation and covered bond transactions have particular requirements, which need to be recognised and facilitated

182. A core objective in any securitisation transaction is to isolate the securitised assets from the other assets and risks of the originator (in US terminology this is known as 'true sale'). Accordingly, the securitised assets should be segregated from the originator for the benefit of the parties to the securitisation, principally the providers of funding used to finance the acquisition of such assets, but also the other creditors of the buyer of the assets. It is therefore critical that multi-seller SPV (Special Purpose Vehicles) buyers are able to segregate their assets, so that the parties that funded or are involved in a particular transaction do not compete with parties to other transactions for repayment out of the assets involved in such transaction. Assets can be isolated statutorily if applicable laws and regulations so provide

51 See chapters on Consumer Confidence, Distribution and Collateral respectively.

183. Another objective for originators in securitisation and covered bond transactions was not to affect relationships between originators and their customers, by notifying them that receivables due from such customers have been transferred. Consequently, in most cases it was considered important that isolation was achieved without notifying the debtors of the sale to the buyer.

184. More generally, it was considered that the time taken and cost involved for originators to securitise assets is often materially affected in Europe by the absence of widely understood market standards of origination procedures. Frequently, originators need to undertake system and process re-engineering to be capable of securitising assets and meeting investors and rating agencies standards. In this context, it was felt that bolder steps were needed to enhance market liquidity and create a dynamic European secondary market for mortgage loans. This required minimum standardisation and stronger cross-border activity such as asset transfers. Additional steps were needed to enhance the liquidity and strengthen the decentralised character of the European secondary mortgage credit market.

185. Initiatives oriented towards deepening the secondary market in bonds, such as the Jumbo bond market developed in Germany in the 1990s, could be expanded to the European level. A European initiative could be self-regulated and entail the creation of an organised market in cooperation with the main relevant stock exchanges, common issuer and issuance standards, including admissible credit enhancements and a common liquidity support strategy. An initiative for European mortgage bonds could be matched on the MBS side.

186. Mortgage collateral of different issuers could be pooled across the border in joint vehicles, in order to create larger primary and secondary market liquidity. Such a step could require the adjustment of particular national regulations. Securitisation transactions rarely involve assets governed by the laws of different countries, in an effort to reduce legal, financing and compliance costs and achieve economies of scale. In the future, if the obstacles to cross-border lending are reduced or even overcome, there could be the potential for Jumbo cover bond issues, where the cover pool assets involve assets from different countries. However, if the documentation transferring the assets must be governed by the same laws governing the creation of such assets, the parties will be forced to either (1) conduct expensive and costly due diligence and prepare different documents for different assets, or (2) drop all but the local assets from the transaction. Either result would deny the originator the full benefit of the pooling together of assets.

187. Focussing on such assets, for a more efficient secondary market between the European countries, it would be crucial for mortgages to be easily transferable to other banks (especially mortgage banks), refinancing vehicles and SPVS (in the case of securitisation) without much expense and effort. Therefore, a simple way to transfer mortgages must be introduced. This would be the case if in all countries it were possible for a bank to hold for another bank or financial institution a mortgage loan or mortgage instrument in the capacity of a trustee, where the interests of that other bank or institution were protected by law, especially in the event of insolvency of the trustee. This would allow the transfer of the beneficiary ownership to the SPV or bank, without transferring the legal ownership. Therefore, if a loan were to be sold to another bank for funding purposes, it would not be necessary to add registration costs. If bank one went bankrupt, the second bank would have the right to extract the mortgage.

188. Furthermore, Industry Representatives considered that simplicity and ease of such transfers would be enhanced if consumers were allowed to accept another country's consumer protection laws (provided that a sufficient level of harmonisation had been achieved), a proposal advanced by them elsewhere in this Report. This would also ensure that lenders would have at their disposal a greater pool of loans that could lead to higher securitisation and/or mortgage bond volumes. Consumer Representatives maintained their opposition to this for the reasons set out in the earlier discussion, mainly the difficulty consumers would face in making a choice between different jurisdictions and consumer protection rules.

189. Finally, the Forum Group discussed new initiatives which could enhance the development of a secondary loans market and contribute towards further integration.

190. In this context, the Forum Group supported the creation of new structures (including those such as the UK trust), which could facilitate the emergence of market-driven multi-origination platforms. It was considered that market forces had not yet created the fundamental conditions for the development of a large and liquid secondary market in Europe, which naturally created a role for the European regulator to stimulate developments and innovation in this field. Any EU initiatives/actions should however assure that the single market's architecture was safeguarded and its core principles maintained and further developed. Consequently the Forum Group opposed any initiatives aimed at introducing any form of institutional guarantee and support (from either the EU or national governments) that might distort competition or create barriers within the national and the European markets

191. The first specific new initiative considered was the European Mortgage Finance Agency project mentioned previously. A major obstacle to the creation of this Agency was represented by the request for an EU guarantee, which the Forum Group perceived as inconsistent with the efforts undertaken so far to increase competition and market efficiency. Although the creation of a pan-European facility aimed at further developing both the mortgage bond and the RMBS markets would be beneficial to both lenders and borrowers, the Forum Group considered that such a facility should be organised and run as a private corporation. Accordingly, The Forum Group believed that one single institution for the entire European banking industry, along the lines of US Government Sponsored Enterprises, (i.e. Freddie Mac and Fannie Mae whose activities are supported by an implicit government guarantee), would not be consistent with the free market principles prevailing today. Such an institution would not provide the necessary conditions of efficiency and competition for the operation of instruments such as covered bonds or mortgage backed securities.

192. The second specific new initiative considered within this discussion was the Euromortage, described in the Collateral chapter, and supported in this context. The Forum Group considered the principal advantage of the Euromortgage from a funding perspective, to be its increased flexibility, allowing consumers to transfer from one lender to another, without having to take out a new mortgage deed. Another advantage would be the possibility to take out several loans with the same guarantee. For lenders, this mechanism would enable the provision of mortgage credits across borders under uniform legal provisions and with greater financing flexibility.

Recommendations

45 The Commission should harmonise legislation regarding segregation of assets, in order to ensure equal access to securitisation for originators located in different jurisdictions.

46 The Commission should enact legislation that recognises the legal separateness of a securitisation vehicle from an originator of assets in the event of the insolvency/bankruptcy of such an originator, even if the securitisation vehicle is part of the same group of companies as the originator.

47 The Commission should investigate and address tax distortions, in order to ensure the removal of differences in fiscal treatment between local and foreign lenders.

48 The Commission should investigate and address national legislation which prevents or hinders the pooling of mortgage collateral from different issuers based in different jurisdictions.

CONCLUSION

193. The Forum Group conducted an in-depth analysis of the 5 key areas identified at the start of its deliberations, for eighteen months. Discussions were lively and rich, with the diversity of members' backgrounds and experiences being reflected in the diversity of views contained in this Report and in its Recommendations.

194. Forum Group members agreed on the majority of Recommendations, with a minority of Recommendations being endorsed by only one or other of two main groupings within the Forum Group, Industry Representatives and Consumer Representatives.

195. Altogether, 48 varied and wide-ranging Recommendations have been formulated and addressed to the Commission. The Forum Group recognises that action on these Recommendations requires careful consideration by the Commission and further wide-ranging consultation. It welcomes such deliberation and the planned examination of the costs and benefits of further integration of the EU mortgage credit markets. At the end of this process of analysis and consultation, Forum Group members appreciate that their Recommendations will be pursued to different extents, within different time-scales and that some may not be pursued at all. That said, they firmly believe that action on single Recommendations or even particular categories of Recommendations, will not achieve the goal of integration. So in conclusion, the Forum Group urges the Commission to assess the Recommendations as a complete package before making any decisions, in taking forward its development of policy for the further integration of the EU mortgage credit markets.

Annexes

I. The Forum Group
II. Consumer Information Research Findings (UK)
III. Stages of the Mortgage Buying Process – Financial Services Authority (UK)
IV. Profile for Risk-Related Criteria for Valuations – European Mortgage Federation
V. The Eulis Initiative
VI. The Euromortgage
VII. Finance

ANNEX I

THE FORUM GROUP

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Working Methods

Five sub-groups were created, to review the five main areas identified by the experts as pivotal to mortgage credit markets integration in the EU : consumer confidence, legal issues, collateral issues, distribution issues and finance.

All issues were first discussed at sub-group level, then presented to the plenary forum for discussion and adoption of recommendations. The Forum Group met on fourteen occasions between March 2003 and November 2004. The Commission chaired plenary meetings, provided secretariat facilities, and meeting rooms for the plenary sessions. Individual sub-group meetings were called on an ad-hoc basis as necessary. Such meetings were kindly hosted by the various European Federations represented in the Forum.

The Commission compiled and edited the Report. The content of the Report is the responsibility of the Forum Group.

ANNEX II

CONSUMER INFORMATION RESEARCH FINDINGS (UK)

There is concern amongst consumer organisations about the way that information is provided to consumers at the pre-contractual stage of mortgage purchase. This situation results in a type of information-based market failure, whereby consumers in the market are being forced to take purchase decisions absent the necessary information. Paradoxically for policymakers, the issue is not that the information is not available (as in traditional information-based market failures). The concern lies with perceived inefficiency in the amount and manner of provision of such information. Three factors have been identified:

- Volume of Choice: The sheer breadth of choice in retail financial services is bewildering. There were at least 30,000 financial products available on the UK market in 2002[1].

- Elusive Needs Analysis: Given the sheer breadth of choice in the market, consumers have difficulty determining precisely what type of product is the most suitable for their specific needs. In a market no longer characterised by 'one size fits all', consumers need to know their individual 'size'.

- Product Complexity: Even if consumers can determine what type of mortgage they seek, they are faced with increasingly complex and exhaustive terms and conditions, bundled products and added features. Put differently, consumers may identify their size, but finding it is no longer a question of simply 'reading the label'.

There seems to be a consensus from several research projects that the principle of providing key features of the product in a summary document (similar to the ESIS[2]) would address this inefficiency. These include Consumers' Association, 'Buying Money Products' (1998) and Mortgage Code Compliance Board, 'Consumer Research Report' (2003). The most extensive research of this nature was conducted by the UK Financial Services Authority (FSA) between 2000 and 2003 involving a total sample size of 294 consumers, in preparation for its impending statutory mortgage regulation. The FSA presented its detailed findings to the Mortgage Forum Group [Consumer Confidence Sub-Group] on 22 March 2004. This research project comprised four key strands, each entailing qualitative in-depth interviews with different sets of consumers, from varied social and geographical backgrounds.

- Strand 1: The sample consisted of first-time buyers, remortgagers and those moving home. Consumers were asked how they approached mortgage-buying, what they knew already, and what type of information they used most at the various stages.

Consumer Research 8: Choosing a Mortgage: report of a research review and qualitative consumer research on the mortgage buying process (London: Financial Services Authority, June 2001). Centre for Housing Policy, University of York, and Reflections Communications Research Ltd.

- Strand 2: Consumers were given samples of mortgage advertisements in circulation in the UK in 2000-2001 and asked questions about them. They were also asked to comment on the usefulness of the ESIS and a more detailed document proposed by the FSA.

Annex A to Consultation Paper CP98: Research on Advertising and Product Disclosure (London: Financial Services Authority, June 2001). Reflections Communications Ltd.

- Strand 3: Consumers were asked to work with examples of proposed disclosure documentation and advertising requirements to assess their usefulness.

Consumer Research 14: Better Informed Mortgage Customers: Research on Financial Promotions and Product Disclosure in the Mortgage Market (London: Financial Services Authority, August 2002). Reflections Communications Research Ltd.

- Strand 4: Further testing through consumers of disclosure documents to assess readability and usefulness.

Consumer Research 17: Initial Disclosure Documentation Research: Research on Disclosing Information about the status of the firm the service offered (London: Financial Services Authority, January 2003). IFF Research Ltd.

These four research projects culminated in the formulation of the Initial Disclosure Document (IDD) providing details of the commission/costs/administration or handling charges associated with a mortgage contract; and the Key Facts Illustration (KFI) providing details of pre-contractual information on the mortgage highlighted:

- The IDD is given to the consumer at the first contact with the lender or intermediary.

- The KFI which goes beyond the requirements in the European Standardised Information Sheet (ESIS), is given at the earliest stage after the lender has outlined a suitable mortgage product for the consumer.

1 Source: Mintel, 2002.

2 This is the European Standardised Information Sheet created by the Voluntary Code of Conduct for Pre-contractual Information for Home Loans, established in March 2001. See Chapter 1 of the Report for further details.

ANNEX III

STAGES OF THE MORTGAGE BUYING PROCESS - FINANCIAL SERVICES AUTHORITY (UK)

Stage	Phase	Regulatory objectives	Tools and requirements
Shopping Around Stage	Phase 1: Consumer is trying to find out about mortgages and do some basic shopping around (i.e. make comparisons). In most cases there is no contact with the lender, but if there is, the consumer is not providing information to potential lenders.	• to help the consumer in assessing affordability and risk. • to assist in shopping around. • to assist financial planning	• financial promotion materials provided by firms (advertisements, marketing brochures etc). • comparative information tables. • consumer education/public awareness initiatives.
Pre-Contractual Stage	Phase 2: Consumer is certain that they want a mortgage. This is the first point at which the consumer is willing to provide information to potential lenders and/or intermediaries. Any shopping around might be over a restricted product range. Consumer has generated a short-list of possible mortgage lenders but continues to shop around in more detail.	• to help the consumer in assessing affordability and risk. • to assist in shopping around. • to help the consumer understand what range of products is being considered in any advice given and what commission is being paid to the adviser.	General information on the mortgages on offer. The lender requires information from the consumer on precise needs, capabilities, financial situation, etc, before a most suitable product can be suggested.
	Phase 3: A mortgage offer is made by the lender.	• to help the consumer in assessing affordability and risk. • to help the consumer to check that the product details match those previously agreed.	**Pre-Contractual Summary Document** provided by lender. Harmonised conduct of business rules to ensure document is given in the right time/manner.
Contractual Period	Phase 4: Mortgage agreement. The consumer receives the contract and is asked to read and sign. The mortgage agreement becomes legally binding (subject to termination provisions).	• to ensure the consumer understands all aspects of the product. • to ensure the consumer understands the obligations, and is aware of the risks of breaking the contract.	Mortgage contract with key financial information clearly indicated in a summary box within the agreement. A list of risks and obligations associated with the contract (i.e. warnings of not meeting the terms of the agreement).
	Phase 5: Post-sale confirmation of the product bought (and initial payments due etc) is provided by the lender. Contract termination ("cooling off") period.	• to provide the consumer with a definitive reference document to ensure the consumer is fully satisfied with product. • to help the consumer to check that everything has been set up correctly.	• up-dated specified (and personalised) disclosure document provided by lender instructions to end mortgage agreement In accordance with DMD requirements where applicable.
Post-Contractual Stage	Phase 6: Cooling off period ends. Contract can now only be terminated subject to penalties.		
	Phase 7: Post-sale, the lender provides regular information about the status of the mortgage and advance information where mortgage features change. The consumer may consider shopping around again – i.e. going back to stage 1 or 2.	• to help the consumer to avoid arrears. • to help the consumer check that payments and charges are correct. • to assist the consumer in shopping around (i.e. to remortgage).	• annual specified (and personalised) disclosure document provided by lender. • event-driven letters from lender

ANNEX IV

PROFILE OF RISK RELATED CRITERIA FOR VALUATIONS: THE EUROPEAN MORTGAGE FEDERATION [3]

Introduction

The European Mortgage Federation recommends that particular risk related criteria (set out below) should be used when preparing and interpreting property valuations for lending purposes.

The recommended risk profile can be used by lenders to obtain additional information that would improve their recognition and management of risk. The profile is intended to enhance the quality of valuations by covering what could be of interest to all mortgage lenders.

Of course there are other criteria that can be considered by professionals in assessing risks, such as partnership risks and financial risks.

Rationale for a risk profile

The risk profile builds on the conclusions of the 1998 comparative study by the European Mortgage Federation, 'The Valuation of Property for Lending Purposes in the European Union'. Property valuation is increasingly recognized as a core criterion for the optimal measurement and management of credit risk by mortgage lenders.

In this context, the risk profile can be seen as a tool to manage and reduce risk. It should prove useful in improving the quality of valuations and increasing the credibility of valuation with supervisors, especially as credit institutions strive to develop and to gain approval for their domestic rating models.

Valuation and lending practices

The valuation of property can be a different albeit complementary act to risk assessment in the granting of a loan. In some countries, valuation is internal to the financial institution and an integral part of the risk management process. In other countries, the valuation process occurs independently of the lender. This difference reflects the different valuation traditions in the European Union.

Where the valuation process is independent of the lender, valuers do not have information about the financial arrangements or about the borrower. However, credit officers do have such information, which they can use together with the valuation report. For example, the loan to value ratio falls under the heading 'financial risks'. The valuer should not take these into account when determining the value of the property, confining him/herself to the kinds of criteria suggested in the risk profile. On the other hand, the credit officer, when considering a mortgage loan application, should take into account also other risks such as financial risks.

Different valuation approaches

The recommended risk profile is not linked to a specific valuation approach (for example, comparative or income based). This enables users of valuations from different valuation traditions, to use the profile to assist with the interpretation of any kind of valuation report.

3 The description in this annex is a summary of that provided by the European Mortgage Federation.

Profile of Risk Related Criteria for Valuations

ALL TYPES OF PROPERTY

A valuation of property for lending purposes should reflect the following risk criteria:

1. Market Risks

- Timing (present market conditions)
- Market cycles
- Market volatility / stability / liquidity
- Demand and supply
- Economic stability of the market
- Market structures
- Attractiveness of regional markets
- Investor or owner occupier driven market
- Behaviour of the market participants
- Demographic trends
- Labour supply
- Other investment opportunities

2. Location Risks

- Planning and development of the immediate neighbourhood and the greater surroundings (micro & macro)
- Development of the region, the city and the district
- Competition: micro-trends of the local economy / other alternative investment opportunities at local level
- Suitability of the location for investment, revenues and increases in values
- Infrastructure
- Public utilities / local supply
- Attractiveness of the location for businesses

3. Construction related property risks

- Physical / architectural issues / quality of the property (fitting out, age et cetera)
- Maintenance requirements
- Economic efficiency
- Marketability and appropriateness for third party users
- Flexibility for other types of use
- Contamination / polluted land
- Reconstruction cost

4. Tenants / Leases

- Strength of tenants
- Reputation of tenants
- Cash flow risks
- Strength of investor

5. Fiscal risks

- Current tax situation
- Potential positive / negative changes
- Local tax regime
- Regional incentives

6. Legal risks

- Ownership
- Planning permission
- Country specific lease structures
- Subsidies
- Efficiency of enforcement (repossession) and forced sale procedures
- Liability for contamination

ANNEX V

THE EULIS INITIATIVE

Property information is held in registers in most European countries. The individual national land and cadastral registers have evolved to meet the national legal and administrative requirements of the countries they serve. In the EULIS initiative, official land registration organisations from eight European countries have cooperated to develop a pan-European land information service. To date, the initiative has been supported through the European Commission (Information Society Directorate General) eContent programme. The aim of the initiative is to demonstrate how a pan-European land information service could be designed to meet the needs of lending institutions and their representatives, and other potential users. In particular, the EULIS initiative seeks to address three major problems that those seeking to access property information held in other countries face: lack of ready access to property information, lack of knowledge about processes in other countries and language difficulties. The project began in 2002 and was completed in mid 2004. It has had a positive response. The participants are keen to develop it further, within the EU and beyond in the rest of Europe.

How EULIS works

Registered land information from national portals will be presented through the EULIS portal. This will be done without altering the information or otherwise processing it in any way, in order to ensure its authenticity. Initially, the register information will be presented in the language of the originating country, with the possibility of including translations in the future. For each country, basic descriptions of legislation and land transactions (including the mortgage, conveyancing and survey processes) are provided. These descriptions have been developed to facilitate consistency and comparability of information from all participating countries. In addition, a list of just over fifty common terms has been developed, with English definitions including reference to particular divergences in national systems.

The service is intended to be easy to access. The EULIS portal will simply be added as an option in the ordinary national service. Thus users will normally need to be registered with one of the participating land information agencies, to comply with any restrictions in information handling.

Assessment of EULIS

EULIS is a practical solution. It recognises the differences between the different legal environments and it enables users to understand and work with them. It provides the basic information required for making secured credit transactions, at relatively low cost and in a relatively short time, thereby also encouraging best practice. It is at a stage of development where further expansion is called for and would be welcomed by all, but without access to funding sources to facilitate such development.

ANNEX VI

EUROMORTGAGE

Introduction

The term 'Euromortgage' or 'Euro – Hypothek' is used in many different ways. Here, it is used to represent a security instrument[4] (collateral/mortgage deed), that can be used to encumber properties in a pan-European sense and with greater flexibility of use than that offered by purely domestic security instruments. There are existing flexible domestic instruments such as the German 'Grundschuld' and the Swiss 'Schuldbrief', which have been studied in formulating these views on a Euromortgage.

The Need for a Euromortgage

Consumer Demands

There is an increased need for flexible security instruments, because of a trend towards loans of a shorter duration, and associated desirability in this context to be able to re-use the security, use it for different purposes and to use it across borders.

Market Demands

There is an increased need for flexible security instruments due to the development of a secondary market including MBS (Mortgage Backed Securities), covered bonds and syndication, and also to facilitate effective risk management generally.

Legal Characteristic of the proposed Euromortgage

In order to fulfil the needs of consumers and the market and have the effect of promoting greater flexibility and further integration of the EU mortgage credit markets, it is considered that any Euromortgage should have the following characteristics:

- Be decoupled from the loan agreement completely (to avoid the disadvantages of accessoriness explored in the chapter on Collateral Issues)
- Be capable of being used to pledge more than one property
- Be capable of pledging properties across borders
- Be easy to transfer
- Be secure – that is, enjoy a secured position in the event of the insolvency of the mortgage holder

How the Euromortgage should be introduced

Given the pan-European nature of the model proposed, it is considered that the Commission should be responsible for introducing legislation on a Euromortgage, on a minimum harmonisation basis.

The Commission could achieve this by:

- Introducing the Euro-Mortgage as an instrument by way of EU directive/regulation;
- Regulating the Euro-Mortgage through a clear definition of the instrument in the directive/regulation; and
- mandating Member States to introduce any consequential changes required to their legal systems, within clear parameters set by the directive/regulation.

4 The loan agreement is a separate issue to the security tool. It is not explored in any detail in this exposition of the Euromortgage security tool.

ANNEX VII

FINANCE
I. COVERED BONDS

Introduction

With the introduction of the Euro, covered bonds[5] have undoubtedly developed into one of the dominant components of the European bond markets. The covered bond product, market share and legislation are developing rapidly. The total volume outstanding at the end of 2002 amounted to € 1.5 tr, which is equivalent to 17% of the European Union bond market, although this figure is increasing, especially with the entry of the new EU Member States and the issuance of structured covered bonds. The importance of the bond market as a source of funds for mortgage credit institutions varies significantly from one country to another. Countries which traditionally have had recourse to the use of mortgage bonds are Denmark, Sweden, Germany, and, more recently, France and Spain. Germany is the largest issuer of covered bonds, with the total outstanding volume at the end of 2002 amounting to €1,100bn (c. 39% of the total German capital market). Denmark, the second largest issuer in Europe, had a total outstanding volume of mortgage bonds of €191bn at the end of 2002.

Covered bonds are an attractive financial asset for a variety of different types of investors, ranging from small private investors to large institutional investors. Insurance corporations and pension funds are the dominant investor group, although credit institutions are also a significant investor in mortgage bonds. The holding of covered bonds by investors located outside the country of issuance has risen steadily over the last years and this trend is expected to continue. In Germany, for example, about 22% of the volume of Pfandbriefe outstanding is in the hands of investors outside Germany[6]. This high volume is due to the high liquidity of the Jumbo Pfandbrief market.

The growth in covered bond issuance, largely inspired by the success of the German Pfandbrief in Germany, has resulted in a number of measures to reactivate the use of these instruments (France) or to introduce them (for example, Ireland in 2001, Sweden in 2003 and Norway in 2003). Such measures are being undertaken elsewhere to differing extents (including Germany, Portugal, Belgium, Italy and the UK).

From a regulatory standpoint the term ‘mortgage bond’ has indeed been used in the past, but increasingly the term ‘ covered bond’ is being used as a replacement to identify a secured bank obligation which merits a risk-weighting lower than the normal 20%. Mortgage bonds, which comply with the standards set out in Article 22.4 of the UCITS Directive [7], benefit from a 10% risk-weighting.

The UCITS Directive allows investment funds to invest up to 25% of their assets in covered bonds from a single issuer, provided that the issuer and bonds satisfy certain criteria. The criteria, set out in Article 22(4) of the UCITS Directive, are used as reference in European directives regulating the conduct of banks and insurance companies. The criteria can be summarised as follows:

- The issuer has to be a credit institution and subject to specific public supervision with the aim of protecting the bondholders.
- The bonds under consideration must be covered and should grant preferential rights (i.e. privilege of the bondholder) with respect to the repayment of principal and interest accrued in case of default on the part of the issuer.
- The means derived from the issue of the bonds must be invested in assets which provide sufficient cover for the entire duration of the corresponding bonds.
- Member States must notify the European Commission.

II. RESIDENTIAL MORTGAGE-BACKED SECURITIES (RMBS)

The total volume of RMBS issuance in Europe in 2003 amounted to €110bn. The main issuers of RMBS are the UK, Netherlands, Spain, Italy and Germany, with the UK RMBS dominating the market (currently c. 50% of all RMBS issuance). However, with the appearance on the market of ‘structured’ covered bonds, some issuers are now shifting away from MBS and towards covered bonds as an alternative source of funding.

UK RMBS

In recent years, securitisation has become widely used by the largest UK lenders as a means of diversifying their funding sources (the costs of securitisation have tended to put limits

5 There are two types of covered bonds, mortgage bonds covered by mortgage loans (property as collateral) and those covered by public sector loans.

6 “Mortgage Banks and the Mortgage Bond in Europe”, 4th Edition, November 2003, European Mortgage Federation.

7 Undertakings for Collective Investment in Transferable Securities (UCITS) Directive 85/611/EEC as amended by Directive 2001/108/EC.

on the market). Such has been the rate of this growth, that the UK is now the most active securitisation market in Europe in terms of the value of the issuance. In the second quarter of 2003, 36% of prime residential issuance emanated from the UK. In addition, in the same quarter, there were both sub-prime and equity release mortgage issuances. At the end of 2003 the total volume of issued UK RMBS stood at €49.6bn, and at the end of the first quarter of 2004 the total volume of outstanding UK RMBS stood at €144.9bn.

The prime UK RMBS sector, as defined by master trust issues, remains in relatively vibrant health. Master trust RMBS are now estimated to represent c. 16% of all European RMBS[8]. Despite HBOS's recent covered bond issuance, most issuers will continue to utilise the master trust format, because funded RMBS offers capital relief to banks under current Basle rules. Following the success of the HBOS issue, other UK issuers (Northern Rock and Bradford & Bingley) have entered the market.

III. MULTI-ORIGINATION PLATFORMS

CRH (France)

Caisse de Refinancement de l'Habitat (CRH) is a French credit institution, the only purpose of which is to act as a funding vehicle in connection with the lending by French banks against mortgages on housing property. CRH funds the loans to the banks by issuing covered bonds rated Aaa/AAA, by Moody's and Fitch respectively.

CRH was established in 1985, in connection with a reform of the French mortgage banking market. It is owned by the banks that use the company as funding provider. The ownership shares of the banks are adjusted on an on-going basis to reflect the respective shares of the banks in CRH's loan portfolio. The largest shareholders are Groupe Credit Mutuel CIC (40%), Crédit Agricole (30%) and BNP Paribas (11%). Agreements between the shareholders prevent the dominance of individual shareholders as no shareholder, regardless of its ownership share, may exercise voting rights equivalent to more than 15% of the share capital.

Total lending granted since the establishment of CRH in 1985 amounts to approx € 25bn.

Collateral

CRH's issuance of high-rated, covered bonds is underpinned by a number of collateral-related aspects:

- A loan portfolio secured on housing properties.
- Rules governing maximum Loan To Value (LTV).
- Unfunded loans remain on the balance sheet of the lender bank, but CRH has an unconditional right to take over both the loans and the mortgages in case of the insolvency of the lender bank.
- Overcollateralisation. The lender banks are required to provide CRH with collateral by way of mortgages of a value of no less than 125% of the amount for which covered bonds have been issued.

CRH's rights to the loans and mortgages in the event of the insolvency of the lender bank, depend upon special legislation in France. Therefore, such a structure cannot be transferred to other countries without similar provision.

By virtue of CRH's articles, its shareholders/borrowers must inject capital, in order for CHR to maintain an appropriate capital adequacy level. Each bank is required also to make back-up liquidity facilities available to CRH equivalent to 5% of the individual bank's loan portfolio with CRH.

Financial risk

CRH does not incur any interest rate and currency risk, as the loans granted are funded via the issuance of covered bonds, at terms completely matching the loans granted. The institution does not charge any margin on the funded loans, but generates income solely via the interest received on capital and reserves. All costs related to the issuance of bonds are paid on a pro rata basis by CRH's customers/shareholders.

Support in connection with establishment

When CRH was established, the company was supported by a government guarantee on the bonds issued. The guarantee was limited to three years and lapsed at the end of 1988. The provision of the guarantee was conditional on a number of collateral-related features.

It is assumed that the government guarantee has had a favourable effect on CRH, but in the light of the other investor protection measures, it has hardly been conducive to CRH's access to capital markets. The lapse of the government guarantee in 1988 had no notably negative effect on CRH's funding costs or access to raise funding via the bond market.

TOTALKREDIT (Denmark)

Totalkredit is a Danish mortgage bank, the only activity of which is to provide funding for the lending by 106 local and regional Danish banks, against mortgages on owner-occupied dwellings. The funding is provided via Totalkredit's balance sheet, while a number of functions such as the credit assessment of customers and property valuations are handled by the arranger bank, which also guarantees the part of a loan that exceeds LTV of 60%. Totalkredit funds its lending activities via the issuance of covered bonds (mortgage bonds). The bonds are rated Aaa by Moody's.

8 ABS Week – European ABS Market Commentary, Royal Bank of Scotland, 5 September 2003.

Totalkredit was established in 1990 by re-activating an inactive mutual mortgage bank. The mortgage bank was converted into a limited company, with the arranger banks acting as shareholders. Ownership shares are adjusted on an on-going basis to reflect the respective banks' shares of Totalkredit's loan portfolio. At the end of 2002, the largest shareholders were Jyske Bank (20%), Sydbank (10%) and Spar Nord Bank (5%). Agreements between shareholders prevent the dominance of large shareholders.

Collateral

Totalkredit's issuance of high-rated covered bonds is underpinned by a number of collateral-related aspects:

- Loan portfolio is secured on real property.
- Legislation provides strict rules on maximum LTVs and related matters.
- There are credit guarantees for the part of the loan that exceeds a LTV of 60% from the arranger bank.

In addition, Totalkredit's shareholders have provided a joint and several guarantee to the company, covering 1% of the loan portfolio. The guarantee covers all losses not covered by the individual bank guarantees. Finally, Totalkredit has taken out credit insurance that covers any other losses from a foreign bank.

Financial risk

Totalkredit does not incur any interest rate, currency or liquidity risks, as the loans granted are funded via the issuance of covered bonds at terms completely matching the loans granted.

Support in connection with establishment

As indicated above, the establishment of Totalkredit was in fact a re-activation of a 'dormant' mortgage bank, that ceased issuing new loans in 1972. The company had capital and reserves of more than €125m which, in accordance with its articles, would be lost if the company did not resume its mortgage lending activities. The banks behind Totalkredit therefore had an important incentive to re-activate the company and considerable 'free' capital for start-up and development costs.

On 1 November 2003, the banks behind Totalkredit sold the company to the competing mortgage bank Nykredit. Nykredit acquired 52% of the shares in Totalkredit and has an option to buy the remainder. In connection with the acquisition, Nykredit has formed a strategic alliance with the 106 banks behind Totalkredit and agreed to continue Totalkredit's concept and business model. However, the banks' joint and several liabilities to the extent of 1% of the loan stock have lapsed.

CREDIT CIRCLE (Italy)

The Italian lending market is very fragmented, with many lenders. Approximately 45% of total lending is undertaken by a large number of medium and small banks, and the remaining 55% of the market is dominated by 10 large banks. A different project is underway, to create a secondary mortgage market. "Credit Circle" has been set up; a market place where one can list portfolios and find investors. The idea is to try to access secondary markets for mortgage loans through market forces and create greater liquidity.

The loans traded in the Credit Circle platform are all performing loans, credit claims on Italian residents and covered by Italian law, with the provision for the possibility of trading loans originated abroad by originators with a legally constituted head office in Italy.

For listing on the secondary market, loans must be grouped (by technical form or other criteria) into "negotiable loan portfolios" of at least €10 million. The platform supports banks in creating negotiable loan portfolios (NLP) and in trading, with the following services:

- It defines standard information requirements for the various types of loans required for 'loading' them onto the platform, facilitating comparability.
- It makes available to the originator a software tool for simulating NLPs to offer on the secondary market, through their 'extraction' from the overall database using certain search criteria (for example, technical form and residual maturity).
- It permits originators to publicise on screen the NLP selected. In this way the NLP and its basic characteristics are made visible to all members of Credit Circle.
- It enables bidders to show interest in an NLP in electronic form. In case of acceptance by the originator, the deal is 'closed' on the platform itself.

While in the case of purchase of a portfolio the contract is effectively concluded within the market, securitisation is more complex, in that it entails a mandate to the bidder to structure the securitisation of the NLP. For this reason, two different forms for expression of interest have been devised, one for the purchase of the NLP and another for the securitisation mandate.

The parties have an obligation to notify Credit Circle of the conclusion of the transaction and its nature.

The market comprises two classes of authorised intermediaries:

Originators, which may be banks and financial intermediaries doing business in Italy under Article 107 of Legislative Decree 385 of 1 September 1993 (the Banking Law);

Bidders, which may be companies authorised in Italy to purchase loans, to structure securitisations, and conduct transactions involving the transfer of insolvency risk. Specifically, this includes banks, non-bank financial intermediaries entered in the special register, closed-end investment funds operating in Italy that engage on a professional basis in financing in the form of credit acquisition, companies authorised to provide on a professional basis credit derivatives and insurance companies.

The creation of a new portal will facilitate the pooling of small portfolios and will enable smaller companies to gain access to a wider audience. The new market will allow cost savings in active loans portfolio management.

AYT (AHORRO Y TITULIZACIÓN)

Cédulas Cajas (AyT) are fixed-rate covered bonds that are collateralised by Spanish mortgage bonds (Cédulas Hipotecarias). The individual savings banks separately issue cédulas hipotecarias that are purchased and repackaged by AyT, which adds a credit enhancement in the form of the additional cash reserve, before issuing the AyT cédulas. All the cédulas issued by the savings banks have the same coupon, maturity and payment date, and the AyT is issued to match these details. Credit enhancement via a cash reserve to be held by AyT and other features make the product more bankruptcy remote than conventional cédulas hipotecarias. In addition, the investor has access to a regionally diversified portfolio of individual lenders, thus potentially reducing default risk and enhancing liquidity. From an issuer perspective, the AyT structure provides access for small issuers to the jumbo market.

AyT Cédulas are issued by AyT Cédulas Cajas FTA, which is a bankruptcy remote fund that is regulated under Spanish law. The fund has been created for the sole purpose of purchasing CHs and issuing bonds.

Collateral Pool – Eligible Assets

AyT Cédulas are collateralised by cédulas hipotecarias issued by savings banks. These cédulas are backed in turn exclusively by mortgage loans with the following eligibility criteria:

- The LTV ratio is 80% for residential and 70% for commercial mortgages.
- Only first lien mortgages are eligible, which need to be legally registered in the National Mortgage Registry.
- An independent and authorised appraisal company must value property.
- The property must be insured for the total amount of its value.

Bankruptcy Remoteness

In case of liquidation of one or more of the savings banks, any shortfall in interest payments will be covered through the cash reserve. The outstanding AyT will be amortised by the amount of the cédulas called. As a further guarantee, the savings banks have also agreed to repurchase the AyT Cédulas at market price or par if partial amortisation is triggered, therefore offering the investors another layer of protection. In addition, the Sociedad Gestora has priority claim on the assets of the mortgage pool of the bank, another form of protection for the investor.

As a result of this bankruptcy remoteness, AyT Cédulas have been granted AAA and Aaa ratings by S&P and Moody's respectively.

Cash reserve

The AyT Cédulas offer an additional guarantee to investors in the form of a cash reserve. This cash reserve is provided to the issuer by the savings banks and offers the creditor the first line of creditor protection. If one of the savings banks were to go bankrupt, any shortfall in interest payments would be paid from the reserve.

Strong collateralisation

The AyT Cédulas are backed by cédulas hipotecarias and so include mandatory over-collateralisation of 11%, as required under Spanish law (this is a feature unique to Spanish covered bonds). Cédulas hipotecarias cannot be issued for amounts greater than 90% of the unamortised amount of all the qualifying loans, giving the 11% threshold. In the event of default, cédulas hipotecarias holders have priority claim on the pool of assets over other creditors apart from the Spanish tax authorities and employees. The high quality of the mortgage portfolio offers additional comfort for the investor.

IV. EUROPEAN MORTGAGE FINANCE AGENCY (EMFA)

The European Mortgage Finance Agency project was initiated in November 2003. It is a private sector initiative, said to be supported by a number of European banks, the goal of which is to establish a European-based government sponsored enterprise similar to Fannie Mae or Freddie Mac in the US. The proposers of the EMFA seek backing in the form of a sort of a guarantee from the EU, but with risk capital to be provided by the private sector, to establish a unified secondary mortgage market across the EU, allowing lenders in each country to access the same funding source on the same terms.

The EMFA seeks to create a pan-European capital market in mortgage-backed securities and to encourage the growth of long-term fixed rate mortgages without early redemption fees.

Its proposal is based on similar publicly-supported mortgage lending institutions in Hong Kong, Canada, the US and elsewhere, which provide long-term funding by selling bundles of mortgages to investors. They do so by creating a unified, liquid secondary mortgage market (i.e. a market that allows investors to fund mortgages directly rather than through banks' balance sheets).

The EMFA would market mortgage-backed securities in a standard format and guarantee to make good shortfalls in repayments of principal and interest by mortgage borrowers. In return for any backing given as sought, it is envisaged that the EU could set targets for the agency and appoint some directors.

However, the project will not succeed without EU backing and the Commission has repeatedly opposed public guarantees by Member States that risk distorting equal access to capital markets[9] . In capital markets today, a public guarantee would severely distort competition vis-à-vis private issuers.

9 EU law (Article 87 and 88 of the EC treaty) outlaws state aid in the form of guarantees, as there may be an element of competitive distortion.

THE FEATURES OF DIFFERENT KINDS OF MORTGAGE CREDIT PRODUCTS

Loan products	Variable-rate	Fixed-rate	Fixed-rate	Fixed-rate
Funding	Deposits Bond issuance Special deposits	Deposits	Non-callable bonds	Callable bonds
Product features	Variable interest rate. The interest rate is fixed on the basis of either external (official) reference rates or internal rates fixed at the lender's discretion.	Fixed interest rates are typically offered for shorter periods (up to 1-2 years). Via financial contracts, the lender hedges mismatches between fixed-rate lending and variable- or short-rate deposits.	Fixed interest rates are offered throughout the loan term (up to 30 years). Yields-to-maturity depend on developments in capital markets.	Fixed interest rates are offered throughout the loan term (up to 30 years). Yields-to-maturity depend on developments in capital markets and include a risk premium for prepayment.
Prepayment and costs related to prepayment	Generally possible to prepay upon expiry of every rate-setting period without any extra cost.	Indemnity is payable. Typically equal to the net present value (NPV) of the yield spread between the time of loan issuance and the time of prepayment for the remaining term until expiry of funding.	Indemnity is payable. Typically equal to the net present value (NPV) of the yield spread between the time of loan issuance and the time of prepayment for the remaining term until expiry of funding.	Always access to prepay at a maximum at nominal value of debt without extra cost.
Customer advantages	Often lower interest rate at the time of loan issuance given a normal interest rate structure. Continuous access to prepay without extra cost.	In connection with fixed interest rates, future payments on the loan will be known. Provides protection against interest rate rises.	In connection with fixed interest rates, future payments on the loan will be known. Provides protection against interest rate rises.	In connection with fixed interest rates, future payments on the loan will be known. Provides protection against interest rate rises. Customers do not incur any interest rate risk.

				In periods with rising yields and falling house prices customers are secured against capital losses, because the customers may prepay loans at a discount (cheaper than when the loan was raised). "Danish mortgage credit system".
Customer drawbacks	Customers bear the risk of interest rate rises. Rates are not always linked to a fixed index. Spreads (margins) are not fixed throughout the term of the loan.	In general, higher interest rates than if variable. Uncertainty about the fixing of indemnities. Customer incurs the risk related to falling yields which may lead to capital losses.	In general, higher interest rates than if variable.	Slightly higher interest rates than those of loans funded via non-callable bonds (insurance premium for the constant option to prepay at low cost).
Credit institution drawback	Liquidity risks	Interest rate transformation and liquidity risks	Low interest rate and liquidity risks if prepayment is excluded during fixed rate periods. If not = liquidity risk	No liquidity and interest rate risks.