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Joint comments of the Zentraler Kreditausschuss, German Insurance Association and German Association of Private Building Societies on the European Commission's White Paper on the Integration of EU Mortgage Credit Markets

1. Introduction

In its White Paper on the Integration of EU Mortgage Credit Markets of 18 December 2007, the European Commission outlines a number of measures aimed at promoting the integration of mortgage markets in the EU. These markets, which account for 47% of EU GDP, play an important macroeconomic role. The objective is to increase their efficiency and competitiveness for the benefit of Europe's consumers and mortgage lenders.

The Commission believes the need for its initiative is backed up by the findings of a study published in 2005 by London Economics, which estimates that improving the integration of Europe's mortgage markets would generate an increase of 0.7% in GDP and 0.5% in private consumption over the next ten years. In the view of the Commission, the following shortcomings of the mortgage markets currently prevent this potential from being realised:

- underdeveloped cross-border business in mortgage lending
- limited product diversity
- low level of consumer confidence
- insufficient customer mobility.

The measures under consideration for eliminating these shortcomings include legislation, self-regulation, recommendations and further studies. All future measures will be subject to the findings of thorough impact assessments. This would also apply to a proposal for a directive on mortgage credit, which, while not announced in the white paper, is not ruled out as a possibility depending on the results of further analysis.

2. The Commission's case for action

As our associations pointed out in their response to the 2005 Green Paper on Mortgage Credit, the conclusions of the study by London Economics do not stand up to critical analysis.

The study's assumptions are essentially based on British market mechanisms, which cannot be applied to other EU member states. The leverage effect on the economy as a whole presupposes that property prices will rise continuously – as was the case in Great Britain until recently – thus generating a permanent increase in value for home owners which can then flow into private consumption (equity release loans). This mechanism was supported by a substantial subprime market opened up by British mortgage lenders along the lines of their US counterparts. The growth rates in this market turned out to be unsustainable. In light of the current subprime crisis it is no longer tenable, in our view, to base the case for action on the arguments of London Economics for improving the internal market.

3. The objectives

3.1. Facilitating the cross-border supply and funding of mortgage credit

Recent surveys have shown that cross-border mortgage lending is driven by supply, not demand. It is normally mortgage lenders who make the first move across their national borders. But a number of obstacles make it difficult for them to establish themselves in the new market and earn a satisfactory return:

- lack of distribution channels
- physical distance from customers
- difficulties assessing creditworthiness
- high processing costs of adapting to local market conditions
- unfamiliar market and property risks
- different types of property lien
- low interest margins.

The challenge is therefore to find the most suitable business model for developing a significant volume of cross-border business. Globally active banks have responded to the above difficulties by establishing or acquiring subsidiaries in other member states to tap into the internal market. This means, however, that they do not operate on a cross-border basis but as a local competitor offering locally familiar and locally approved financial products.

Neither non-German suppliers in Germany nor German suppliers in other member states encounter any restrictions on mortgage lending or on establishing subsidiaries or branch offices. Only non-deposit-taking institutions without a banking licence are not allowed to grant mortgage loans in Germany. This is in line with current German banking supervisory law and is necessary to protect consumers and avoid competitive distortions. In the US 60% of subprime loans were granted by institutions without a banking licence.

We continue to take the view that the only realistic way of integrating the markets is by creating liquid secondary mortgage markets, broadening the funding basis and developing new funding tools. Investment in foreign mortgage portfolios would help to diversify risk and optimise funding. Tradable mortgage receivables with the aim of making it easier to transfer claims secured by property liens would do much to encourage the creation of such a liquid secondary market.

The development of pan-European funding strategies would lead to greater cost efficiency. *Pfandbriefe* (German mortgage bonds) have long been eligible for funding mortgage loans throughout the EU. There are complex legal and tax problems associated with the use of mortgage-backed securities, however, when it comes to establishing special-purpose vehicles and assembling cross-border mortgage loan portfolios. But these problems are mainly rooted in national tax law and rules governing the transfer of receivables, i.e. they are outside the scope of the measures envisaged by the white paper. Progress in these areas is also dependent on possible changes in the regulation of securitisation markets currently under discussion by European regulators and lawmakers against the backdrop of the subprime crisis.

3.2. Increasing product diversity

There are no restrictions in Germany on the types of product or product combinations which may be sold. The product range includes mortgages with a high loan-to-value ratio, (periodically) redemption-free loans, forward loans, interest-only loans, loans permitting repayment in instalments, variable rate loans and loans with a combination of fixed and variable rates. Banks have recently begun to offer mortgages that may be repaid in full at any time with an interest mark-up of 30 to 60 basis points to cover the repayment option.

In principle, there are no limits to increasing product diversity. Any new types of product must, however, make economic sense and satisfy a demand, i.e. meet customers' needs. The unrestricted introduction of mortgage loans that may be repaid at any time would be incompatible with the

provisions of the German *Pfandbrief* Act (rules on mortgage cover, problems of matching interest rates and maturities between the *Pfandbrief* and covering assets). Please see our comments on the November 2005 Green Paper On Mortgage Credit for details.

Products offered in Germany are geared strongly to actual demand. German borrowers have a traditional interest in fixed rate loans (predictability, financial security) and are highly price-conscious (lowest interest rate is the deciding factor). The long-term nature and stability of the German mortgage market are features warmly welcomed by consumers. The benefits of extremely low default rates are passed on to borrowers in the form of correspondingly low risk costs.

In-house credit rating and lending guidelines ensure compliance with specific risk criteria (customer's own equity contribution, lending limits, positive customer cash flow, etc.). A relatively conservative lending policy compared to that in other countries, together with a strong fixed interest culture, makes the German mortgage market considerably less volatile than other EU markets. Given recent market developments, the criticism that there is no subprime segment in Germany is without substance.

It should also be borne in mind that Germany has a well-developed rental housing market to complement the market for owner-occupied property. The allegation that access to home ownership is difficult is made by people who analyse the German market only in terms of ownership levels. In countries where 70 to 90% of citizens own their own homes there is often no real alternative to buying. Germany, in contrast, has a liquid market for rented housing which offers an alternative, economically equivalent access to high-quality accommodation. A number of surveys have confirmed this point. This structural difference between German and other housing markets is often overlooked, giving rise to the erroneous conclusion that funding opportunities in Germany are limited.

3.3. Improving consumer confidence

We welcome the Commission's objective of increasing the confidence of consumers in the mortgage lending market. The European Code of Conduct on Home Loans, which is used in Germany throughout the industry, has a key role to play in this regard. The code, with its European Standardised Information Sheet (ESIS), ensures that customers all over Europe obtain clear, comparable, correct and complete information. Where necessary, customers are also given extensive advice going beyond a description of the product.

Revising the code to reflect recent market developments and include aspects such as cautionary notes or information on foreign currency and equity release loans could help to ensure that it remains a viable alternative to regulation. We are strongly in favour of retaining the code of conduct.

Prudential requirements also guarantee responsible lending practices in the EU. Borrower risk and creditworthiness are determined on the basis of the relevant national legislation (in Germany: the German Banking Act and Solvency Regulation) and with the help of tools such as scoring mechanisms and internal rating models especially designed for this purpose. The key factors in a lending decisions are the value of the collateral and the probability of the borrower being able to repay the principal and interest within the agreed period. Developments similar to those culminating in the US subprime crisis are therefore not to be anticipated in the EU.

3.4. Facilitating customer mobility

Keen competition and a high degree of transparency on products and prices are significant features of the German mortgage market. There are no restrictions on customer mobility. In particular, borrowers are not, as in some other countries, required to open a current account or take out an insurance policy with the company granting the mortgage loan. A mortgage agreement is only combined with mortgage redemption insurance if this is useful for tax purposes and requested by the customer (the insurance is a separate product in its own right). Risk or term insurance may be taken out at the customer's request to cover the mortgage loan in the event of death. There are no adverse implications for customer mobility.

The cost of switching financial service providers is much lower in Germany than in other member states because the use of a property charge (*Grundschuld*) rather than a strictly accessory mortgage means that no new property charge needs to be created and registered in the event of assignment or revaluation. Germany has the most flexible property collateral mechanisms in the EU.

In addition, mortgage loans can be transferred to other properties and/or acquired by property buyers. Products can be combined and funding structured in such as way as to offer an optimum solution tailored to the customer's personal circumstances.

We reject the impression given by the Commission that the repayment regime for German fixed rate loans restricts customer mobility. Mortgage loans are repayable at the end of every fixed interest period and after ten years at the latest without any restrictions or early repayment penalty.

Customers can also, in the event of a legitimate interest and for a possible early repayment charge, repay the loan during the lock-in period. Borrowers are basically free to choose the length of the fixed interest period to suit their personal needs and/or make arrangements for repayment in instalments, thus ensuring maximum flexibility. As mentioned above, customers can also opt for variable rate loans, which are not subject to any early repayment charges.

4. Achieving the objectives

4.1. The need for legislation

The Commission announces in its white paper that it intends to carefully analyse the need for legislation. Its internal impact assessment concluded that market integration can only be achieved by means of legislative measures in the following four areas:

- early repayment
- pre-contractual information
- annual percentage rate of charge
- responsible lending.

We strongly argue against regulating the mortgage market at European level. We fail to understand why the Commission believes that the integration of mortgage markets can best be achieved by concentrating on consumer protection measures. As it correctly points out in the white paper, integration will essentially be supply driven. Consumer protection driven integration and product harmonisation will deliver no added value for the internal market. Introducing restrictions on the product side, especially on early repayment, would merely serve to limit product diversity and undermine the Commission's declared objective of integrating mortgage markets in an optimum manner.

Early repayment

Our associations especially reject the view of the impact assessment that differences in rules on early repayment across the EU are the main obstacle to further integration of the mortgage markets. This assumption cannot be justified on economic grounds. These differences are, on the contrary, an expression of the product diversity in Europe which the Commission purportedly wishes to promote.

For the same reason, we are also unable to agree with the objective set out in the impact assessment that consumers in the EU should be able to repay their mortgage loan at any time for a fair and objective price and should not be tied to a mortgage agreement for a long period of time.

Fixed rate loans serve consumers' interests because they offer planning security. Long-term fixed interest periods allow consumers to protect themselves against rate increases. The subprime crisis shows that this protection can be of existential importance. This is why the security and predictability of principal and interest payments is so highly appreciated by German borrowers. Fixed rate loans have a stabilising effect on the economic situation of borrowers and at the same time offer them access to favourable interest rates.

Studies have shown that the average margin in mortgage lending for banks and insurance companies in Germany is only 35 basis points. One of the main reasons for such favourable interest rates is the fact that there is no need to factor in mark-ups for early repayment risk.

When mortgage loans are available at similarly low interest rates in other member states, this is normally due to strategic considerations. Companies offer mortgage credit below or at cost price with the aim of establishing long-term customer relationships during which they can earn a positive overall return by cross-selling other products. This strategy carries considerable interest rate risk and substantial losses can build up over the life of the mortgage loan. Such banking practices cannot, in our view, serve as a model for the European Union, especially in light of the lessons learned from the subprime crisis.

Interfering with German lending mechanisms could damage the German fixed interest culture and reduce the availability of agreements with long-term fixed interest periods. Such a development would be at odds not only with consumer protection but with efforts to improve financial stability.

What is more, consumers in Germany have a wide range of products from which to select the type of funding that suits them best. Our comments on the November 2005 Green Paper on Mortgage Credit went into all technical and consumer aspects of the early repayment issue and pointed out that permitting customers to repay their loan at any time without allowing banks the possibility of charging a penalty in the event of loss would increase interest rates for borrowers by 30 to 60 basis points and be incompatible with the principles of *Pfandbrief* refinancing. Please see these comments for further details.

Against this backdrop, we are somewhat taken aback by the Commission's stance on the costs associated with a right to early repayment at any time. It recognises that legislation would have an adverse effect on the price of mortgage loans but nevertheless takes the view that the benefits of regulation would generally outweigh this drawback. An unquantifiable added value delivered by regulation is thus given preference over the concrete existing benefit to consumers offered by lower interest rates.

Furthermore, we do not consider it a viable option to revise the law governing German *Pfandbriefe* to satisfy the requirements of future EU legislation on early prepayment in the form under consideration by the Commission.

Pre-contractual information requirements

Our associations strongly advocate retaining the European Code of Conduct on Home Loans as the principal driver of market integration. The code satisfies all requirements concerning product transparency, pre-contractual information and comparability. These are the key criteria for judging the suitability of any mechanism in an environment of increasing product diversity across the EU.

The banking industry has repeatedly expressed its willingness to update the code. We continue to urge the Commission not to call the undeniable success of the code into question by future measures.

Annual percentage rate of charge (APRC)

We pointed out in our comments on the 2005 Green Paper on Mortgage Credit that harmonising the method of calculating the APRC on a narrow cost base would improve customers' ability to compare different products. This continues to be our position. The question as to the most suitable policy option for this purpose needs to be explored further, however. We firmly believe that the calculation method proposed for the new Consumer Credit Directive would not make it easier to compare APRCs for mortgage loans.

Responsible lending

It is important to avoid drawing the wrong conclusions from the subprime crisis when it comes to considering how borrowers' creditworthiness is assessed in Europe. Given the existing prudential

requirements in the EU, undesirable developments along the lines of those in the US are virtually inconceivable.

As pointed out above, the use of internal models and rating systems which are regularly monitored by national supervisors ensures that lending practices in the EU take adequate account of the risks involved and of the borrower's financial capacity. We see no need for further action, especially along the lines of a "responsible lending" commitment. Establishing new liability provisions runs the risk of making banks less willing to lend with the result that access to credit would become more difficult, especially for consumers with lower credit ratings. Prudential requirements to evaluate creditworthiness must remain totally separate from requirements under contract law. Ensuring easier cross-border access by lenders to credit data and/or linking up credit registers across the EU would help to eliminate obstacles to market integration.

4.2. Valuation and land registers

We welcome the initiatives announced in the white paper, which are to be presented in the course of the year as a Commission recommendation. This applies both to the electronic link-up of land and mortgage registry offices or the establishment of internet-based access to these offices (EULIS) and to the Commission's interest in reliable and converging valuation standards in the EU.

All these measures not only have the potential to enhance market efficiency but are essential, in our view, if obstacles to cross-border funding are to be eliminated.

4.3. Infringement policy

We support the Commission's intention to examine whether national legislation governing covered bonds contains restrictions on including non-domestic EU mortgage loans in cover pools.

4.4. Mortgage Funding Expert Group

In our view, the capital markets offer the most effective means for the time being of moving forward the integration of Europe's mortgage markets. Progress depends, however, on a liquid secondary mortgage market and on improved access for mortgage lenders to long-term refinancing funds.

It is regrettable that the white paper does not comment on the recommendations of the Expert Group on Funding but merely announces further research.

It would be considerably easier for banks and insurance companies to tap the internal market if they could diversify risk by acquiring foreign mortgage loan portfolios or consolidate cross-border loan portfolios. This requires above all progressive rules on the assignment of receivables and flexible real estate liens.

The ability to transfer mortgage credit is the key to an efficient and liquid market for portfolio transactions. Portfolio transactions enable banks to diversify their risks over the capital markets and optimise the refinancing of their loans.

Securitisation presupposes the ability to outplace loans and thus generate fresh capital for new business. The ability to outplace credit risk is one of the major elements of a modern financial market and requires corresponding rules governing the assignment of receivables.

The cross-border dimension of both the market for portfolio transactions and the securitisation market highlights the potential of the capital markets to help integrate Europe's mortgage market.

Refinancing requires the establishment of a broad investor base which will succeed in covering the need for capital in the mortgage lending business in the long term. Access to refinancing funds and adequate liquidity are top priorities for the banks, as the current turmoil in the capital markets has shown.

The German *Pfandbrief* has proved its worth during the market turmoil, whereas the securitisation market has not lived up to investors' expectations. Against this background, we welcome the Commission's plans to set up an Expert Group on Securitisation to recommend ways of modernising the securitisation market.

Crucially important, in our view, is that banks have access to long-term refinancing funds which will enable them to meet consumers' similarly long-term funding needs. In times of crisis fixed rate loans prove to be a badly needed cornerstone of stability.

In a fixed rate regime changes in the interest rate only affect new contracts and contract renewals. As a result, both average interest rates and property prices are subject to far smaller fluctuations. It can be demonstrated that residential property prices rise much faster in countries with mainly

variable rate mortgage loans than they do in countries where most loans have fixed interest rates (see DB Research: “The real estate sector in relation to monetary policy”, 20 December 2007). At the same time, fixed rate loans reduce the risk of default since an unfavourable interest rate environment cannot in itself cause a borrower to become over-indebted.

4.5. Further research

Opening up mortgage lending to non-banks would be highly problematic, in our view. We firmly reject the idea of mortgage loans from institutions which do not have to comply with the rules of financial services regulators or which do so only to a limited extent. Extensive prudential rules guarantee high standards of lending by banks, insurance companies and building societies. This protects consumers. Furthermore, considerable competitive distortions would arise if mortgage loans could also be granted by market participants which are not subject to this stringent prudential regulation. In light of the subprime crisis the Commission would, moreover, need to demonstrate how responsible lending, financial stability and effective supervision could continue to be ensured if non-banks became active in the mortgage lending business.

5. Conclusion

We continue to call on the European Commission to focus primarily on establishing an environment for European mortgage markets which is geared towards stability and to refrain from measures with the potential to undermine this stability, thus generating corresponding financial risks for consumers.

We argue strongly against legislation, especially in the form of a directive to harmonise mortgage credit. Product regulation would reduce diversity and put the German fixed interest rate culture at risk. Instead, self-regulation should be systematically expanded, i.e. the Code of Conduct on Home Loans and ESIS should be revised and infrastructure measures should be promoted through a Commission recommendation addressed to market participants and member states.