

ZENTRALER KREDITAUSSCHUSS

Members: BUNDESVERBAND DER DEUTSCHEN VOLKSBANKEN UND RAIFFEISENBANKEN E.V. BERLIN • BUNDESVERBAND DEUTSCHER BANKEN E.V. BERLIN
BUNDESVERBAND ÖFFENTLICHER BANKEN DEUTSCHLANDS E.V. BERLIN • DEUTSCHER SPARKASSEN- UND GIROVERBAND E.V. BERLIN-BONN
VERBAND DEUTSCHER PFANDBRIEFBANKEN E.V. BERLIN

Comments of the Zentraler Kreditausschuss¹ on EU Commission Consultation Paper “Responsible Lending and Borrowing in the EU“

12.08.2009

¹ The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks financial group, and the Verband deutscher Pfandbriefbanken (vdp), for the mortgage banks. Collectively, they represent more than 2,200 banks.

I. General

ZKA (Zentraler Kreditausschuss) welcomes the opportunity to share its comments during the consultation conducted by the EU Commission concerning the issue "Responsible Lending and Borrowing in the EU".

Before addressing the specific questions posed by the EU Commission, we should like to seize this opportunity to make a number of general points related to the present debate. Most of the undesirable developments mentioned in the Consultation Paper – especially in the field of mortgage loans – cannot be found in Germany. In Germany's banking sector – unlike the US – irresponsible lending with loan amounts in excess of 100% (partly up to 120%) of the lending value granted to borrowers with low creditworthiness does not form part of standard market practices.

Rathermore, in Germany, loan amounts in excess of 100% of the lending value are – if at all – exclusively granted to borrowers with outstanding creditworthiness. The securitisation of high-risk mortgage loans (sub-prime lending) whilst using the product variant "originate-to-distribute" was primarily developed and practised in the US. Hence, it does not come as a surprise that the current crisis took its origin in the US, which is where, in our view, there is an urgent need for action concerning the structures of the retail credit market; whilst not limited to, this especially refers to lending standards. Standard market practices here in Germany do not feature any such approaches involving a transfer of high-risk loans. However, as a result of globalised financial markets, the distribution of the securitised loans has also affected other countries, including Germany. This is primarily due to the purchase of such loan securitisations by financial market players. Yet, the EU-wide crisis is first and foremost a liquidity and confidence crisis. It is not a crisis that takes its origins in the structures of European credit markets, let alone retail credit markets. Hence, there is no need for implementing solutions within the EU that seek to address erroneous developments in the US.

The Consultation Paper gives rise to the impression that the mortgage markets in the EU were unregulated markets. This is not the case. Either in toto or after corresponding adjustments, the large majority of Member States also apply the National consumer credit provisions to the field of mortgage lending.

Already today, German banks take lending decisions only after a comprehensive analysis of the borrower's creditworthiness. In this regard, the Consultation Paper fails to adequately

reflect the respective rules and regulations in the field of banking supervision. In Germany, any lending decision without a prior analysis of the creditworthiness would constitute a violation of prudential banking supervision legislation (especially but not limited to MaRisk). At this juncture, precisely those parameters are being verified that are also being addressed in the Consultation Paper. This shall always be the case, regardless of whether in the final analysis the loan is e.g. being funded by a subsequent securitisation, mortgage bonds or deposits. Hence, as far as the financial service providers in Germany that are already covered by prudential supervision are concerned, there is no acute need for action with regard to measures concerning responsible lending in the retail sector. “Untied” credit intermediation is the only area where measures might be adopted so as to safeguard a level playing field on a par with those financial service providers who are already covered by prudential supervision.

In Germany, today’s credit sector is already marked by a large number of rules and regulations (German Banking Act (KWG), German Civil Code (BGB), Unfair Competition Law (UWG), Price Indication Ordinance (PAngV), Minimum Requirements for Risk Management (MaRisk)) meaning that additional regulatory provisions should only be contemplated under due consideration of the EU Commission’s “better regulation” principles. Furthermore, the Consumer Credit Directive envisages a series of innovations for the credit sector - in Germany this shall also include the area of mortgage lending; yet, its transposition into applicable national law is only due for June 2010. Based on the foregoing, it would appear premature to reopen the debate on the issue of responsible lending which has only just been concluded before having fully validated the results that will materialise during the implementation of the Consumer Credit Directive in this field.

II. Questions by the EU Commission

Question 1: Do you have evidence of misleading or unfair advertising or marketing practices with regard to mortgage and consumer credit?

We are not aware of any evidence for misleading or unfair advertising or marketing practices in the German credit sector. Misleading commercial actions are already sanctioned under general competition law. The Directive on Unfair Commercial Practice (2005/29/EC) has been implemented into national law only recently. This Directive explicitly regulates misleading information, even if the misleading nature is due to an omission, i.e. non-disclosure of certain issues. The misleading nature can inter alia be triggered by wrong statements or disclosures which help obscure material features of the service - for instance in terms of risks and advantages or fitness for purpose.

Furthermore, Germany can draw upon the Price Indication Ordinance² which stipulates, inter alia, that the total cost of loans has to be shown in the form of an annual percentage rate of charge (APRC). The Price Indication Ordinance stipulates that this APRC has to be calculated in a certain way thus safeguarding comparability of the price quotations issued by different providers and ensuring clear and precise consumer information concerning the level of the forthcoming annual outgoings. This rule is not limited to consumer credits and therefore also applies to mortgage credits.

Compliance with these rules is closely monitored by consumer associations and by competitors. For the implementation of consumer protection rules, there are also further tools on which consumer associations can draw, e.g. the German Act on Injunctions for the Protection of Consumers' Interests (UKlaG).

Contrary to the US, Germany has never featured moral hazard in combination with initially interest-free and/or redemption-free products. On the whole, we have no evidence for erroneous developments with regard to sales or marketing of credit products. This has also been confirmed for the area of mortgage lending in Germany by surveys initialised by the Commission.

Question 2: What are your views on the development of risk guidelines?

In our view, significant progress in the field of risk awareness amongst consumers can only be achieved by enhancing consumer know-how with regard to financial matters (financial education). We therefore explicitly welcome the initiatives by the European Commission in this field.

Precontractual information cannot remedy the shortcomings in general financial know-how lest this would lead to an information overload. Here, primarily national governments are called upon. By means of instructing the corresponding financial know-how at schools, they need to further enhance their endeavours in this field. But also the financial service providers support consumer know-how in financial matters through a host of instruments.

Furthermore, as far as credit advice is concerned, whenever necessary also the risk pointers concerning the credit products demanded by consumers along with general information are standard market practice already today. Of course, the customer shall invariably also receive

² As published in the notice of 18 October 2002 (Federal Gazette I 2002, p. 4195), amended by the Act of 3 July 2004 (Federal Gazette I 2004, p. 1414).

information on the specific risks of their credit exposure whenever this is being requested. The implementation of the Consumer Credit Directive in Germany shall also see the introduction of mandatory general information concerning credit products including special risks both for consumer credits and also for mortgage credits. What is more, already today such general information exists within the framework of the application of the code of conduct for mortgage lending that is being supplemented by the European Standardised Information Sheet (ESIS).

Question 3: In your view, are there certain (categories of) credit products that are inherently unsuitable for sale to retail borrowers? Would you welcome a set of standardized or certified credit products to be offered to consumers?

Already today, retail banking, – i.e., for instance also the consumer credit business or real estate financing (60% lending value; annuity loans with 1% redemption plus saved interest) – is part and parcel of standard credit business. Should a consumer opt for these products, they will receive credit products of a similar design from a host of providers, the mere difference being the terms like, for instance, the interest modalities; yet, any other product features will be identical.

Especially the German real estate finance market is characterised by largely standardised, long-term fixed interest loans. The fixed interest periods guarantee planning security in terms of the forthcoming financial payments to be made thus furthering the borrower's economic security. This has proven to be especially potent consumer protection particularly during the present financial and economic crisis. There are no indications that there might be unsuitable products in the field of real estate finance here in Germany.

A certification of products would inevitably lead to a drain on product innovation. In view of their stigmatisation (i.e. precisely the lack of a certificate) the demand for noncertified products could see a significant drop and this might result in a displacement of these products from the market. This could restrict product choice for consumers. Not all credit products that differ from standardised retail banking transactions are per se "an issue" in terms of consumer protection. Apart from this, certified products do not have to be per se better than noncertified products. A certification might even lead to a misinterpretation on the part of the consumer. For instance in the investment area, Germany's so-called Riester pension scheme products come with a disclaimer on their certificate issued by the competent certification authority which explicitly states that the certificate is not an indication of the product's economic viability.

Apart from this, standardisation and potentially certification leads to more red tape potentially driving up costs for these products - costs which eventually will have to be borne by the consumer. To date, as far as we know, the experience with certified credit products at a national level has revealed a negative track record. For instance, due to a lack of interest, one certified mortgage credit product in the UK had to be taken off the market again after its launch.

Question 4: Do you consider that mortgage lenders and credit intermediaries should always perform creditworthiness and/or suitability assessments before granting consumer and mortgage loans? For mortgage credits, what are your views on the criteria to be used in assessing suitability such as loan-to-income ratios or loan-to-value ratios?

In Germany, banks already take lending decisions only after a comprehensive analysis of the borrower's creditworthiness. First, such a risk assessment helps meet supervisory provisions particularly within the framework of the second pillar of Basel II/CRD. Second, such a review is also in the vested interests of banks. During this exercise, banks have to rely on the completeness and correctness of the disclosures made by the borrower. In this context, it would be helpful if the borrower was obligated to provide complete and correct information. Yet, in practice the enforcement of such an obligation will hardly be feasible because it is difficult to verify the information given (cf. also our answer to question 7).

We strongly object to the establishment of an institutionalised assessment of "product suitability" because such a "process" would be encumbered by considerable "shortcomings". It makes perfect sense and is perfectly right that the consumer ought to receive correct information concerning the product when signing a loan contract. Yet, the responsibility for the decision whether they want to sign a loan agreement and – provided they want to go ahead with it - which content this agreement ought have, rests with the consumer. The information given by the bank precisely serves to facilitate informed and responsible decisions on these matters.

Banks cannot shoulder the decision on whether the loan makes sense, the suitability of the chosen credit type and the risk of application for the consumer. One of the reasons is that de facto the bank is incapable of determining whether the loan is suitable as far as the consumer's specific personal situation is concerned and which type of product may potentially be most suitable for the interests of the customer.

The banking industry, too, is sympathetic to the fact that the EU Commission seeks to provide safeguards for sufficient consumer information during lending decisions across the

whole of Europe. This approach, however, cannot result in an obligation for banks to protect the consumer from him or herself; banks cannot shoulder the risk for consumers that credit funded investments may subsequently turn out to be unsuccessful.

Furthermore, a product suitability assessment may only provide a momentary glimpse and it can only be conducted on the basis of the information shared by the consumer concerning their momentary personal and financial situation. Whenever the consumer's personal situation changes over time, a product which may previously have been deemed suitable may suddenly appear inappropriate. Once the borrowing decision has been made, any potential liability on the part of banks arising from the product choice should absolutely be avoided. In the final analysis it is consumers themselves who make an informed decision after due consideration of their personal conditions. Like with any other purchasing decision for economic products, particularly the assessment of the pros and potentially the cons of the credit product needs to be left to consumers' discretion. Of course, banks will be available with supporting advice services. In fact, this is already the case today.

In Germany, ratios such as loan-to-value or loan-to-income are part and parcel of the credit lending decision. Within the framework of their risk policy, banks need to be given the freedom to handle these ratios in a flexible manner and to determine the respective thresholds on their own. Fixing these ratios to a certain level would be an interference with the lender's business strategy and risk management. Hence, particularly in the field of mortgage loans, we object to supervisory provisions with regard to the loan-to-value ratio or the debt coverage ratio for the lending business.

In the Consultation Paper dated 15th of June 2009, the EU Commission points out that a lender may opt to provide a risky loan (i.e. without a sufficient assessment of the borrower's creditworthiness) because the credit is sufficiently collateralised by real estate which has been furnished as collateral or because the lender can transfer the credit risk by issuing residential mortgage backed securities (RMBS) or even sell the portfolio (cf. page 7 f.). In our view, this is out of step with the reality of standard market practices in Germany.

Usually, loans are held to maturity by banks on their balance sheets; when seen in relation to the total outstanding volume, credit securitisations play but a subordinate role. For instance, as per March 2009, the credit volume in companies and private households in Germany amounted to EUR 2.3 trillion (Reference: German Bundesbank) whilst the outstanding securitisation volume as at the end of 2008 merely amounted to EUR 87.3 billion in Germany (Reference: European Securitization Forum, Data Report Q1 2009). Hence, banks

generally only grant loans if they take it that these will be duly paid back within the contractual term to maturity. Generally, banks are keen on long-term customer relations. This standard market practice in Germany is reflected in low default rates for residential property loans also during times of crisis.

For banks, realisation of the real estate is time-consuming, costly and encumbered by the uncertainty that the sales revenue might not be sufficient for loan redemption. Furthermore, the preconditions for realising a collateral have been specified in greater detail to the benefit of the consumer by the Risk Limitation Act. What is more, due to the envisaged amendments to the legal requirements for such securitisation transactions, a complete transfer of credit risks within the framework of RMBS will henceforth no longer be possible because banks shall have to pay a deductible of 5% of the securitised loans. This means that one of the prime drivers for approving risky loans, or, moreover, for lending without an assessment of the borrower's creditworthiness, will no longer exist.

Question 5: How should the lender or credit intermediary demonstrate or document the adequacy of the creditworthiness and suitability assessment?

We object to a European wide statutory regime for information that needs to be obtained from the customer as per the Markets in Financial Instruments Directive (MiFID) because this would result in considerable extra costs for banks that would eventually have to be borne by consumers. Furthermore, as far as the credit sector is concerned, we feel that such a provision is not fit for purpose. The "suitability assessment" which is required under MiFID is geared towards transactions in financial instruments and is not suitable for loans. This is also demonstrated by the derogations under the Consumer Credit Directive (CCD), which were adopted in the wake of MiFID. Hence, within the scope of the CCD it is left to the discretion of Member States to "... take appropriate measures to promote responsible practices during all phases of the credit relationship, taking into account the specific features of their credit market. (...) The Member States' authorities could also give appropriate instructions and guidelines to creditors..." (cf. CCD 2008/48/EC, Recital 26). There should be an analogue regime for the field of mortgage lending.

This is the only way in which the idiosyncrasies of the markets in the respective Member States can be taken into account adequately. Based on the presentations made in response to question 4 concerning the creditworthiness test conducted by banks in Germany, we feel that there is no need for additional obligations.

Furthermore, in order to be able to keep track of the lending decision in the event of a potential discord, banks generally produce internal records on the information underlying their lending decision.

Question 6: Do you think that these advice standards would be appropriate in an EU context? Are there others that should be considered? What would be the most appropriate means to introduce and enforce the application of advice standards? (Please explain)

Whilst the term “information” refers to the provision of objective data concerning the funding transaction and the product, the term “advice” refers to the recommendation of that product which is most suited to the needs of the customer and their economic situation. Customer advice is a separate service which generally also incurs fees in the form of separate charges.

The underpinning principle of contractual relations in Germany is the principle of “Treu und Glauben” (acting in good faith) which is laid down in section 242 of the German Civil Code. This is the equivalent to the Anglo-Saxon term of “honestly, fairly and professionally”.

Real estate finance or, moreover, mortgage lending is subject to the general disclosure and due diligence obligations that are applicable to the customer care sector in the entire banking industry. We feel that these provisions already provide sufficient safeguards facilitating an informed choice on the part of potential borrowers when it comes to funding their real estate investment. Disclosure obligations need to be limited to spelling out the pros and cons of the products on offer. The respective pointers can be found e.g. in the banking industry associations’ information brochures which are handed out to the borrower before the mortgage loan is taken out. The so-called “responsible consumer“ (“mündige Verbraucher”) i.e. consumers who are capable of acting upon the requisite information in an empowered and self-determined way (informed choice) is the leitmotif under European and German law. In the final analysis, only customers themselves will be capable of determining whether a product meets their requirements or not.

In our opinion, transposing legally enshrined consultancy services standards from other fields – for instance the area of securities transactions – to the mortgage credit sector is not the right move. For instance, the advice needs to be geared towards the respective borrower and their individual situation in life, their income and asset situation; it also has to take account of the borrower’s social environment. Furthermore, in the competitive arena it is precisely the quality of advice which constitutes a unique selling proposition.

In the final analysis, we also feel that extending the scope of the creditor's obligations is also source of great concern as far as liability aspects are concerned. This is due to the fact that a comprehensive advice obligation incurs the risk that customers who are not capable of paying back their loan might challenge the legal title to repayment (or, moreover, they will claim damages) on the grounds that they had allegedly not received correct advice concerning the total loan amount or the credit type.

On the whole, establishing an advice responsibility for banks would lead to restrictions during lending decisions. This would make it more difficult for certain consumer groups to gain access to credit.

Question 7: Apart from a focus on financial education, are there any measures that could be taken to encourage responsible borrowing?

The following fundamental questions arise in this context: How can the consumer be committed to such a behaviour (responsible borrowing) especially the disclosure of suitable, correct and comprehensive information to the lender? Are there any suitable sanction mechanisms for breaches and what would they be?

In this context, during a potentially envisaged regulation of the banks' obligations it will also be necessary to specify in greater detail the disclosure obligations of the consumer. Whilst not limited to, consumers' disclosure obligations might particularly include the following items:

- Their precise address, date of birth, nationality, family status and matrimonial property regime as well as
- detailed information concerning the type and length of vocational activity including the designation of the employer and the industry
- a detailed list of the assets, particularly nature, level and legal grounds of their income (for instance income from self-employed or gainful employment, rental income, income from capital assets as well as other regular income such as child benefits etc.)
- Information on adults living in the same household, dependants as well as children entitled to maintenance,
- A detailed list of the liabilities; whilst not limited to, this should particularly include information on the amount, type and legal grounds of the outgoings (e.g. ongoing costs for a car, insurance, maintenance and support payments, general cost of living, rental payments or home ownership costs, social insurance contributions, savings schemes, encumbrances resulting from other loan liabilities and leasing payments).

Furthermore – regardless of how exact and precise they put the questions to the consumer – banks will regularly be in no position to cover each and any case which may impair the capacity of the consumer to meet their contractual obligations. In order to ensure that the lending decision is taken under due consideration of the consumer’s actual income situation and encumbrances, the consumer must therefore be dutybound to proactively co-operate and disclose information. Whilst not limited to, the latter applies particularly to potential encumbrances.

As far as the consumer’s procurement of information concerned, care should be taken so as to avoid the creation of additional hurdles. For instance, the consumer’s credit score should not be prejudiced if the consumer sends out a request for quotes to several lenders simultaneously for the purposes of comparing their rates.

Question 8: Do you consider that the scope of the definition of Credit Intermediary as set out in the Consumer Credit Directive (CCD) could also be applied to the mediation of credit not covered by that directive? Would it be appropriate to differentiate between full-time credit intermediaries and persons who offer credit intermediation on an incidental basis? (Please explain why / why not)

We feel that, in line with the CCD, a European-wide definition of the credit intermediary would be helpful.

In our view, the differentiation between a full-time credit intermediary and persons who offer credit intermediation on an occasional basis is not necessary. Both variants need to be subject to the corresponding due diligence requirements. Potentially, a lighter regime might make sense for credit intermediaries if and when they demonstrate to have sufficient knowledge in the field of banking or, moreover, a banking licence.

Question 9: Do you think policymakers should make distinctions between credit intermediaries in terms of the products they sell (mortgage, consumer credit, ‘point of sale’ credit)? Should credit intermediaries be treated differently in terms of the status of their relationship with lenders (tied vs. untied intermediaries)? (Please explain your answer)

From our point of view, a distinction in terms of products is not necessary. Credit intermediaries should have to meet the same stringent requirements as the actual creditor. After all, this is the only way for safeguarding high quality consumer advice.

Credit intermediaries for whom already their principal – i.e. banks, insurance companies building societies etc. – is liable (tied intermediaries and intermediaries who only work for one single firm) should be treated in a different way than (untied) credit intermediaries who are not backed by a liable financial services firm that would have to shoulder the liability risk in the event of a potential claim.

Question 10: Could you give examples of cases of misconduct, mis-selling or any other instances of consumer detriment linked to credit intermediaries in your country?

We are not aware of any examples.

Question 11: Does the regulatory patchwork for credit intermediaries present a problem, in your view?

No, to date potentially heterogeneous rules and regulations in Member States have not proven detrimental during the involvement of credit intermediaries based in other EU Member States. In Germany, both insurance and also credit intermediaries need to have a government business license. This business license will not be granted if the respective applicant is found to lack personal integrity and financial robustness. This system has stood the test of time and has also contributed to a high quality standard (cf. also our answers to question 13 and 14 on this matter).

However, frequent changes in various legal fields affecting credit intermediaries (e.g. Consumer Credit Directive or tax rules) present a problem.

Question 12: What would be the most appropriate way to address potential conflicts of interest, particularly with regard to fee / bonus / commission structures? Should any measures in this regard apply to bank client-facing staff as well as intermediaries?

When it comes to credits, consumers receive information in the form of objective mandatory disclosures, e.g. the APRC as well as each and any costs of the product that will have to be borne by the consumer. Any additional information concerning the remuneration level of the credit intermediary does not constitute meaningful information. In the field of banking, the intermediary's remuneration level has no influence on the consumer's decision because APRC allows an objective comparison of the costs for the different competing products. Contrary to this, as far as (high risk) investment products are concerned, any objective comparison results difficult. Therefore, the remuneration of the intermediary plays a certain role during the assessment of potential conflict of interests.

Question 13: What are your views on the registration and supervision of credit intermediaries?

Actually, the fundamental principle “same business, same risks, same rules“ should also apply in this area. At least untied credit intermediaries should be subject to a corresponding registration obligation. They also ought to meet the same requirements as banks in terms of sales. Tied credit intermediaries and intermediaries who only work for one firm (sales agents) are already registered and supervised through the company for which they work.

Question 14: What are your views on prudential and professional requirements for credit intermediaries (such as minimum capital, professional indemnity insurance, educational or professional qualification)?

The respective requirements and obligations for credit intermediaries hardly differ from the requirements for advice given by the lender. Hence, there is no need for separate rules and regulations specifically for credit intermediation. By assigning different roles and responsibilities, by preparing and synchronising job profiles as well as by means of regular and systematic training, not only banks but also their business partners ensure that the preconditions for proficient credit intermediation are being met. The provision of advice by banking employees does not give rise to any liability problems, either.

Such standards should also be secured when it comes to untied credit intermediaries. At this juncture, we should particularly like to mention a professional liability insurance if and when the untied credit intermediary is not insured through the company for which they work.

Question 15: How do you think the activities of credit intermediaries could be brought within existing complaints and out-of-court redress mechanisms?

We welcome the endeavours to establish an out-of-court redress mechanism aimed at resolving complaints that is low-cost for the consumer.

For intermediaries who work for banks or subsidiaries thereof or intermediaries who are contractually bound (tied), potential complaints are already being handled by the respective banks’ or their subsidiaries’ competent dispute resolution boards.

Untied credit intermediaries should be dutybound to install corresponding dispute resolution mechanisms (potentially run by their associations).