

# What level of harmonisation for EU mortgage credit markets?

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**T**he European Commission's proposal to regulate mortgage credit markets is a first step towards a European mortgage market. It imposes a harmonised set of rules on financial institutions and credit intermediaries, largely following those of the 1987 Consumer Credit Directive (CCD), but adding elements that are specific to mortgage markets. Whether a more European-wide mortgage market will emerge remains to be seen, as the level of harmonisation may not be sufficient, many provisions have been left to national implementing legislation, and other elements that impact markets, such as tax, registration or contract law, are not covered. Sensitive items – including house valuation standards and greater specifics on mortgage underwriting, such as maximum loan-to-value ratios – are not included.

On March 31<sup>st</sup> of this year, the Commission adopted its long-awaited proposal for a Directive regulating retail mortgage credit, a subject that clearly ruffles some feathers in the post-financial crisis period. Unlike consumer credit, mortgage credit, accounting for two-thirds of household lending in the EU, has so far not been subject to EU-level regulation. This situation was largely due to the Commission's longstanding assessment that the cost of EU legislation would outweigh the benefits, and that self-regulatory efforts could be more effective (see Commission White Paper, December 2007). By that time, however, the financial crisis had already started, with the demise of several EU banks, often related to the decline in real estate prices. It was also already clear that an industry code of conduct, concluded in 2001, had not worked. The aim of the code was to improve and standardise consumer information, but even for that limited purpose some national associations had refused to sign up. A classic case of self-regulation that had no bite.

The financial crisis proved that EU-wide rules are necessary, and that, despite the fact that markets are still to a large degree idiosyncratic, problems in many markets are similar and do not stop at the border, but have EU-wide ramifications. The Commission is now proposing to follow the approach of the 1987 CCD, with a harmonised annual percentage rate of charge (APRC), minimum pre-contractual information, advertising rules and obligatory creditworthiness and suitability assessments. Specific additions are the right for early repayment and rules on mortgage intermediaries or advisors.

The draft Directive sets the minimum information to be provided in advertising and pre-contractual information, based upon the European Standard Information Sheet (ESIS), to allow the consumer to compare different offers. It introduces 'know your customer' rules and requests lenders to make a creditworthiness assessment, with non-discriminatory access to credit data bases, also cross-border. If a creditworthiness test proves negative, the request for credit has to be declined. Early repayment is a contractual right, but the conditions are left to member states' implementing legislation. Creditors can expect compensation from borrowers for early repayment. However, the draft Directive only states that this compensation needs to be "fair and objectively justified", without setting additional requirements. While regulating fixed-rate products in the manner described above, the Directive says nothing about the application of the APRC to products with variable rates and foreign currency products. And since these are the products that are currently causing the problems in certain markets,

it is likely that unfair product price competition on a non-risk-adjusted basis and higher house price volatility will continue in those markets.

An interesting requirement called for in the Directive is the separation of the cost for the credit (the APRC) from the cost of advice provided to the customer. This also applies to credit intermediaries, which have to provide information on the different levels of commission payable to the banks. The Directive also introduces minimum standards and a single passport for credit intermediaries, which need to be licensed and registered, subject to minimum standards. Elements of the proposal can be adapted by the new European Banking Authority (EBA), under the auspices of the European Commission. This includes advertising rules, pre-contractual information (ESIS), the calculation of the APRC, the rules for creditworthiness assessment and cross-border access to data bases. But the draft does not assign responsibility to the new European Systemic Risk Board for adding measures aimed at dampening mortgage bubbles.

At a seminar on June 23<sup>rd</sup> marking the launch of a CEPS report<sup>1</sup> on the subject, MEPs questioned the objectives of the draft Directive and the level of harmonisation. Rapporteur Antolín Sánchez Presedo argued in favour of a selective targeted harmonisation and to leave room for member states in consumer protection. Shadow Rapporteur Vicky Ford stressed the diversity of mortgage markets in the EU. Owner-occupation ratios are totally different, she said, and regulating loan-to-value (LTV) ratios is not necessarily the solution because it is even more crucial to look at the income of the household in the creditworthiness test. But Ford thought the creditworthiness assessment has gone too far, as lenders should be given some degree of flexibility in order to take into account all the individual aspects, again referring to the country in question and cultural differences. Another Shadow Rapporteur, Sven Giegold, on the other hand, spoke in favour of regulating LTV ratios. In particular, he suggested that LTV ratios should not be fixed but rather should be made dependent on market trends, which could serve as efficient steering tools for the market. He also argued for more uniform, not minimum, harmonisation in order to promote stable developments in the mortgage credit market throughout all member states. The MEPs also questioned the scope of delegated acts for the EBA.

The draft Directive should be considered as a first step, as it leaves much room to the member states for implementation, and it introduces minimum harmonisation of a limited set of elements affecting mortgage lending, which may not go far enough. The Directive regards some conduct of business rules of mortgage lending, but it does not cover prudential matters. It also only applies to retail mortgage credit, but member states could extend it micro and SME credit. Interaction with consumer protection and other forms of non-harmonised national legislation may, however, continue to render cross-border integration difficult.

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<sup>1</sup> The ECRI/CEPS Special Report – “A New Mortgage Credit Regime for Europe” by Hans-Joachim Dübel and Marc Rothemund – is based in part on discussions that took place within the CEPS-ECRI Task Force on A New Retail Credit Regime for Europe – Setting the Right Priorities, which met between May 2010 and January 2011.

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