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The Commission's White Paper on Mortgage Markets: Inching towards consensus…but missing the big picture

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Efforts by the European Commission to harmonise mortgage credit date back to the 1980s. In the past, they invariably produced the same result: exclusion from or special treatment of mortgages within central financial sector directives, on the grounds that these were traditional business processes and funding instruments hinging upon national legal setups. The internal European market was deemed irrelevant. The White Paper on the Integration of EU Mortgage Credit Markets of December 2007 rejects this protectionist line of argument for good reasons, but it pays its dues to the entrenched opposition by pursuing legal and regulatory reforms only in selective areas of early repayment, responsible lending, APRC and precontractual information. Other issues are left to recommendations and a new round of research and stakeholder discussions. Since the paper's formulation last fall, the proliferation of unsound practices in the mortgage sector has culminated in a crisis directly affecting Europe, with the consequence that the legal-regulatory discussion has already moved beyond integration to questions of stability and sustainable sector development. A limited approach like the one adopted in the White Paper cannot begin to address those challenges, nor is it likely to have any greater chance at political success than a more comprehensive one. The current financial crisis offers an important opportunity to introduce reform. The odds are considerable, however, that that opportunity will be lost in the search for consensus down to the very last stakeholder.

The European residential mortgage market continues to be characterised by high idiosyncrasy of loan products, business processes, risk management and funding instruments. Accounting for less than 1% of EU-wide transactions, in contrast to commercial real estate, a cross-border market is virtually non-existent. It has been argued that such idiosyncrasy is primarily a result of the market, reflecting differing consumer preferences and 'natural' market entry costs, such as language barriers or cultural traditions. I disagree with this assessment: regulations, the institutions they create and the policy set-up matter for integration and sustainable development.

THE CASE FOR ACTION: SUB-OPTIMAL SERVICES TO CONSUMERS, HIGH BARRIERS TO ENTRY AND SYSTEMIC FINANCIAL RISK

Three main strategic dimensions of financial integration form a magic triangle: completeness of the product menu (i.e. maximising consumer utility), efficiency of supply and price levels, and soundness and stability. A number of pan-European studies, some of which are quoted in the White Paper, have empirically explored aspects of the first two areas. The third dimension has been brought back forcefully through excesses in the mortgage market both in the US and Europe.

All European mortgage markets are incomplete to a certain degree, concerning missing products (e.g. fixed-rate lending in the UK) or underserved groups (e.g. the self-employed in Germany). Completeness is critically undermined by barriers to entry perpetuated by the unevenness of the legal-regulatory European playing field. Specifically, the Second Banking Directive and its concept of mutual recognition by national regulators have failed to work for large parts of the mortgage sector.

In fact, even in core mortgage products that dominate national markets and in which lenders can build competitiveness on the European level through scale, the internal market remains segmented. A German and a British lender, and a Spanish and a French lender can export their core products to each other's market, but, as a result of barriers embedded in consumer protection rules, a German lender cannot export to France, a Brit not to Spain, nor a Spaniard to Germany,[1] etc. According to conventional industry interpretation, the main culprit here is the priority given to home country consumer protection law by the Rome Convention. Yet, host country control through mutual recognition would be as unacceptable to the consumer side, due to objective insufficiencies in many local consumer protection frameworks. These are most pronounced in accession countries, since mortgages are in large part not covered by the *acquis communautaire* due to their exemption from central EU directives.

In the absence of cross-border trading options, European mortgage lenders have deepened specialisation in their national markets and cut down local prices for mortgages as measured by spreads over funding costs significantly. Nevertheless, spread comparisons are distorted, as an empirical comparison of Spain vs. Germany shows:

- Spain's dominant mortgage product is an adjustable-rate mortgage loan tightly priced over 1-year Euribor. The 2003-05 average spreads for this product were 1.14% vs. 2.39% in Germany.
- The German standard product is a fixed-rate mortgage loan priced over the swap or Pfandbrief curve with a maturity of 10 years or higher. Over the period 2003-05, the spread for 10-year loans in Germany averaged 0.7%, vs. 2.3% in Spain.[2]

Such marked differences in cross-border spreads in products that would appear on standard mortgage market menus anywhere in the world dramatically underline the absence of integration.

However, economy-wide spread comparisons that pool all products, such as those presented by the European Mortgage Federation, obscure this important point.

That said, the mortgage industry is correct in pointing out that there is intense competition within most European markets. Even latecomers, such as Greece or Poland, are rapidly becoming very competitive. I would argue, however, that both the pricing and competition levels to a large degree reflect liquidity effects of an enforced focus on the national market. Comparisons are further distorted by the willingness

[1] France rejects the German yield maintenance prepayment indemnity protecting fixed-rate lenders against reinvestment loss upon prepayment, Spain rejects British practices of reviewable-rate mortgages (standard variable rate) and Germany rejects indexed contracts dominant in the Spanish market.

[2] Data source: Presentation given by Joao Coco of the London Business School to an ECB workshop, June 2006.

of lenders in most European markets to cross-subsidise[3] mortgages as a long-term product leading to higher cross-sales of other financial products. Moreover, in some markets, e.g. Germany, we find dangerous lender policies to artificially lower the price of fixed-rate mortgages by funding them with lower-priced short-term liabilities. The paramount role of large liquidity in single products also favours concentration: most member state markets are served by only a handful of large national players, and there is danger of exploitation of such oligopolistic structures to the detriment of consumers' interest going forward.

Also, national legal-regulatory regimes tend to be biased 'in favour' of lenders providing national core products, which draw the greatest lobbyist pressure. Consider again the cases of Spain and Germany when dealing with early repayment, which is a focus of the Commission's White Paper.

- In Spain, adjustable-rate mortgages may fetch a 1% early repayment fee to stem the loss of servicing profit. Fees on adjustable-rate loans are strictly prohibited by German law, a legal relic of two periods of hyperinflation in the 20th century.
- In striking contrast, under German law, a consumer willing to prepay a fixed-rate mortgages has to pay a yield maintenance indemnity that not only compensates the lender for reinvestment loss but also includes a considerable element of lost servicing profit. In Spain, until a very recent reform, prepayment fees for fixed rate loans were capped at 2.5%, which did not even covered reinvestment loss.

Nationally dominant funding instruments, most notably covered bonds, have reached equally high liquidity levels and low spreads in similarly questionnable ways. In covered bonds, for example, a product relying on particularly high asset safety, the standard is to widen the eligible asset base if a jurisdiction is too small, rather than seeking diversification by accumulating safe assets across borders.

As a result of such makeshift arrangements, the number of covered bond issuers in Europe is expected to surpass 100 shortly, issuing on the basis of two dozen different national laws, with each of them, as a result of national asset concentration and legal idiosyncrasy, being vulnerable to market shocks such as those currently sending Spanish and British covered bond spreads to levels hitherto unseen in the market. The market for mortgage-backed securities (MBS), while somewhat more standardised through the paramount role of rating agencies, suffers from similar shortcomings – for example, idiosyncratic national laws cut an always different path through the jungle of obstacles to securitisation, with many unintended consequences.

This leads to perhaps the greatest failure of integration so far, to achieve sufficient resilience to financial and real estate sector shocks. National funding models, collateral valuation and execution, and regulatory standards still determine what type of risks consumers, or investors/depositors, are exposed to by intermediaries. It is striking that the arguably most developed financial market in Europe, the UK, has still no fixed-rate or interest rate cap market to speak of, leaving consumers vulnerable to considerable interest rate risk.

The UK has also head over heels enabled unsafe US-style subprime credit practices rather than tackling its housing cost (i.e. fundamental borrower solvency) problem. At the other extreme, German Pfandbrief issuers, worried about the stability of their funding instrument, unnecessarily limit consumer mobility by tying them into once closed fixed-rate contracts through legally excluding prepayments. Appraisal methods used in much of Europe are no more effective than in the US, where they helped to boost short-term intermediary profits and left investors with losses and borrowers without homes. Spain, the UK and Poland face comparable housing price risk, exaggerated by weak appraisal and underwriting standards. Finally, investors exposed to any such nationally determined risk can hardly arbitrage between them

[3] Public subsidies play a decreasing role after European markets went through various rounds of denationalisation and subsidy reduction during the interest rate compression period between 1985 and 2005.

given numerous obstacles in creating cross-border asset pools – from access to registries and databases to enforcement.

The White Paper addresses many of these issues – but it does not fully develop the context. Europe is too directly affected by global financial sector trends, and mortgages are both too important and potentially too dangerous a tool to be able to afford neglect of the bigger picture issues – especially those threatening stability.

THE WHITE PAPER'S RESPONSE AND THE BROADER AGENDA

It seems straightforward therefore to call for a more comprehensive agenda of sector reform in Europe. It should focus on what I like to dub the '3 Cs' of mortgage finance: collateral, consumer protection and capital markets policies.[4] The Commission's White Paper does address these areas, but with vastly differing intensities.

In the area of collateral, the White Paper relies entirely on encouraging member state initiative and more generally seems to pursue the old mutual recognition approach. A scoreboard system is suggested to encourage easier access to registries and limiting collateral execution time and costs. Common (and in particular sound) collateral valuation standards are disregarded, although they are a central consumer and investor protection instrument. The call for mutual recognition of 'foreign' valuation techniques instead will rarely boost confidence. The initiative to introduce a 'Eurohypotec', a common legal surety instrument that would facilitate the creation of cross-border collateral pools as well as trading has been delegated back to the industry, where it is likely to dissolve in internal dispute. A toothless approach to collateral policies is also unlikely to convince national covered bond regulators to accept EU infringement policies enforcing the use of collateral from the entire EU territory, given that possible losses will have to be absorbed by the member states.

The picture is brighter in the area of consumer policies, although the long-term goal of fully transposing the Consumer Credit Directive of 1988, or rather its successor passed in 2007, to the mortgage lending area has been abandoned.[5] From the canon of rules of the Directive, with early repayment, APRC and responsible lending, some of the central issues have survived in the White Paper. Yet the politics are not easy: in an unhappy coincidence, the Directive of 2007 had tightened the early repayment indemnity regime for its ambit, which includes home modernisation loans not secured by mortgages, ensuring that lenders will not be able to recover losses (and hence be forced to increase loan margins).

This promises to draw fresh resistance from mortgage lenders even to harmonisation allowing for full loss recovery on their side. Developing a common APRC[6] concept applicable to mortgage lending could indeed support consumer confidence as the White Paper points out. Yet much time has been wasted in the past with the focus on ambit (in- or exclusion of insurance fees, etc.). It is only slowly being recognised that mortgage APRCs that do not consider the considerably varying mortgage product specifics could be misleading in the best case and outright dangerous in the worst case. Examples abound, such as in the case of US subprime loans where APRCs were not quoted to consumers on a fully-amortised, fully-indexed basis, but rather at artificially low teaser rates. Similar practices exist also in Europe. Prepayable

[4] A fourth C that I deem important, competition policies, is left out for space reasons here.

[5] The Consumer Credit Directive of 1988 became fully transposed to mortgage lending only in France and Belgium. All other countries used the options for exempting mortgage credit in specific areas, e.g. Germany in the area of early repayment, or Denmark in the area of the withdrawal ('cooling off') period. The reasons brought forward by the exempting countries were threats imposed by the Directive to the survival of successful national mortgage finance practices, e.g. covered bonds or certain loan products.

[6] Annual percentage rate of charge, a concept for standardising interest rates aimed at greater comparability of loan offers.

mortgages also need different APRC concepts than non-prepayable, mortgages requiring pre-savings need separate treatment, etc.

Much work also lies ahead on responsible lending, an area promoted by the White Paper without much guidance as to the intended action. I believe that if such a route is pursued, it must lead to some form of financial liability assigned to lenders or brokers for a specific canon of infringements. At a minimum, the use of credit risk models that have already become quasi-mandatory in financial regulations should be promoted in consumer loan underwriting.[7] In contrast, a straightforward proposal by the White Paper is to further develop the European Single Information Sheet (ESIS).

Compared with US disclosure rules, and also the Commission's own Consumer Credit Directive, the ESIS avoids the mistake of providing excessive and thereby confusing information to consumers. However, is the intention to make the ESIS mandatory? More generally, the arguments made by the White Paper and the weights ultimately attached in the selection of legal reform areas suggest that the Commission seems not immune to the assumption that consumer information and some form of benign responsible lending commitment should be the central consumer protection instruments. With ample empirical evidence produced by the current mortgage sector crisis, it can be said that this will clearly not be sufficient.

As important material consumer protection questions are left out by the White Paper, such as usury, rate adjustment and risk protections (e.g. on forex or interest rate risk exposure of consumers), loan assignment and the specifics of execution/foreclosure, the question of how to align the internal market goals of the EU with the consumer protection goals of member states remains fully virulent. As the US case with its continued roles of states in consumer protection 75 years after the first federal action in the market shows, this conflict is far from easy to solve.

Yet, a possible road could be to pursue stricter microeconomic cost/benefit reviews of specific regulation proposals on both EU (as promised by the White Paper) and member state level. In my view, such an approach could be extended to a more evidence-based interaction process on issues below a European systemic risk-relevant level. Many consumer protection regulations are appropriate candidates. Similar to the process defined in the Treaty for state aid, member states could be allowed to keep specific consumer protection regulations even if they do establish obstacles to trade and integration, once a cost/benefit analyses has demonstrated their positive net effects. Such rules should be 'sunsetted', i.e. their continuation made conditional on sound evidence produced on a regular basis of their effectiveness – with the onus lying on the side limiting competition, i.e. the member state.

The White Paper finally prioritises action in the area of capital markets, as earlier comparative studies have done. The argument here is a certain degree of industry consensus on the priority, implying lower political resistance, and the notion of a strong indirect impact of lower costs and greater diversity of funding instruments on the key integration goal of product completeness. It does so by advocating 'to facilitate, not restrict' the development of funding instruments. It would be helpful to have a clearer understanding of how this is intended to be achieved: greater clarity of the Commission's intentions surrounding prepayment and especially a more binding approach to the all-important collateral quality issues could support covered bonds, which rely on high asset quality.

A strategy should also be developed that puts an end to the current parochialism of national covered bond laws. The White Paper apparently intends to leave such issues to self-regulation via the European Covered Bond Council (ECBC). Confronted with crisis, that entity in the meantime has broken up into two camps: one advocating stricter standards and a liberal one. It is not unlikely that in the end the Commission will have to arbitrate here. MBS securitisation, a funding instrument serving greater ranges

[7] In that regard, the White Paper consistently fails to make the connection between consumer and investor protection instruments, which pursue similar goals and partly interchangeable instruments (such as capital requirements).

of asset quality, faces the problem of a severe loss of investor trust in rating agencies, which acts as a market-based control mechanism substituting for many of the regulations in the covered bond world.

Confronted with what is essentially a complete market-rebuilding exercise, the Commission should give the industry direction on fundamental issues such as the future of true sales and ring-fencing concepts (also in the light of increasing political relevance of depositor protection), product complexity (which has gone overboard), risk mitigation incentives (which were absent in the endgame of the market) and certainly investor capital requirements. It is unclear what the Expert Group on Securitisation proposed by the White Paper is expected to achieve here without more specific guidance. Finally, the use of capital market mechanisms in general should attract greater support by the Commission, as the bulk of European mortgages are funded by deposits, and intermediaries face substantial liquidity and interest rate risk. This requires further steps in areas such as capital requirements, which currently ignore the correlation between interest rate and credit risk (e.g. in adjustable-rate mortgages) as well as cross-border diversification benefits, and supervisory review.

THE TACTICS OF REFORM - CONSENSUS VERSUS LEADERSHIP

When the author moderated his first European mortgage industry meeting almost 15 years ago, the consensus of the industry was that national business models should remain untouched by any form of harmonisation. In private, participants would comment to him on how unacceptable each other's laws and policies were for their own businesses. This classical coordination failure remains unaddressed, but the good news seems to be that the Commission is still on track to achieve this goal.

What is less clear is whether the piecemeal approach and especially the in-depth involvement of stakeholders pursued by the European Commission following the failed French referendum in 2005, will further at least a narrowly defined integration goal, let alone the more comprehensive sector development approach advocated here. The key triggers of consensus, after all, are financial bottom lines, not discussions. In that vein, it has been impossible in the past to convince lenders to give up their protectionist strategies against the promise of securing the larger integrated European market. This myopia seems paradoxical given that most involved lobbyists were mortgage specialists, which face an existential threat imposed by the combined global forces of global capital markets and universal banking. Yet, perhaps the impact of the financial crisis will raise awareness in this camp that greater coordination and public good creation have their benefits, even in the short term. Similarly, consumer groups may perhaps develop a greater awareness, as a result of the crisis, of the fact that low prices, large numbers of products and availability of lending to low-income households are not a given. Preserving both efficient and complete markets will require a well-balanced and carefully thought-through, rather than restrictive, set of regulations.

The danger is that, as is currently the case in the US, crisis will be abused for calls for a greater role of the state in lending or guarantees, rather than coordination of private players. Explaining, along the example of the US housing agency system, why this would be a road towards even greater risk, would be the subject of another comment.

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