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Accompanying the

White Paper on the Integration of EU Mortgage Credit Markets

IMPACT ASSESSMENT

ANNEX 3: Impact assessment on specific issues

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ANNEX 3: Impact assessment on specific issues

Disclaimer
This impact assessment report commits only the Commission's services involved in its preparation and the text is prepared as a basis for comment and does not prejudge the final form of any decision to be taken by the Commission.

1. CHOOSING A SUITABLE PRODUCT

Taking out a mortgage credit is an important decision for any consumer. In a competitive and efficient market consumers will theoretically shop around for the best offer. To do this, consumers would ideally have correct, complete, comparable and understandable information about the various offers and be financially literate enough to understand the information. They would therefore be able to seek out the best deals to meet their needs regardless of the location of the financial services provider. Mortgage lenders would likewise have all the relevant information to be able to offer consumers a suitable product. However, markets are not perfect. As will be described in Sections 1.1.–1.2., consumers often have low levels of financial literacy and the information provided often fails to fully meet consumer needs. In such instances, it should be ensured that consumers receive assistance in selecting the best product for their individual needs.

1.1. Pre-contractual information

The provision of pre-contractual information[1] is crucial because it enables the consumer to understand the features and risks connected with a certain mortgage product and consequently to use this knowledge to compare this product with other products to make an informed choice. This information also needs to be presented in a way which is easy to understand and has to be given at a time which enables the consumer to use the information to compare the offers available on the market, to assess the implications of the product considered and to take a decision.

1.1.1. Context

1.1.1.1. Pre-contractual information requirements

Depending on their legal traditions, Member States have either specific statutory laws or Codes of Conduct covering information obligations for mortgage credit. In addition, pre-contractual information on mortgage credit is covered by the pan-European 'Voluntary Code of Conduct on Pre-contractual Information for Home Loans' (the Code), which was negotiated between European consumer associations[2] and the European mortgage lending industry[3] in

[1] Information is a description of a given product, either in general terms (objective information) or in a more specific way (specific information). It has to be carefully distinguished from other concepts such as 'advice', where the lender recommends a given product to the consumer. See *Final Report of the Mortgage Industry and Consumer Dialogue*, 20.12.2006, p. 6, http://ec.europa.eu/internal_market/finservices-retail/docs/home-loans/miceg/final_report-en.pdf.

[2] The European Consumers' Organisation (BEUC), Confédération des Organisations Familiales de la Communauté Européenne (COFACE), Institut Européen Interrégional de la Consommation (IEIC), Association of European Consumers (AEC), European Community of Consumer Cooperatives (Euro Coop).

2001.[4] The objective of this Code was to introduce transparent and comparable pre-contractual information for consumers looking for mortgage loans. Under the Code, consumers are entitled to receive general information and a personalised European Standardised Information Sheet (ESIS) before the conclusion of a contract.

The agreement on the Code[5] foresaw two monitoring mechanisms. First, the European Credit Sector Associations agreed to publish an annual progress report on the implementation of the Code. Second, the Commission agreed to monitor the uptake and effectiveness of the Code and to review the operation of the Code within two years of its Recommendation on pre-contractual information to be given to consumers by mortgage lenders offering home loans.[6]

A review of the implementation of the Code, accordingly commissioned by the Commission in 2003, indicated that implementation, at that time, was unsatisfactory.[7] The European mortgage lending industry disagreed with the findings arguing that it had been carried out too early and that the methodology used was questionable.[8]

The European Banking Industry Committee's second progress report published at the end of 2005[9] confirmed that not all European mortgage lenders had yet adhered to the Code. Although adherence and implementation of the Code in some markets was close to 100%, in other markets the situation was less satisfactory. At the end of June 2005, institutions representing only 40% of the French mortgage market had subscribed to the Code with even fewer (institutions representing 30% of the market) having actually implemented it. Furthermore, no Spanish mortgage lender has so far adhered to the Code due to incompatibility between the Code and the national legislation. In addition, although progressing, subscriptions in many of the new Member States remain limited.[10]

1.1.1.2. Annual Percentage Rate of Charge (APRC)

One important element of pre-contractual information is the Annual Percentage Rate of Charge. The Annual Percentage Rate of Charge is that rate, which, on an annual basis, equalizes the present value of all commitments (loans, repayments and charges), future or

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3 European Banking Federation (EBF), European Savings Banks Group (ESBG), European Association of Cooperative Banks (EACB), European Mortgage Federation (EMF), European Federation of Building Societies (EFBS), European Federation of Finance House Associations (EUROFINAS).

4 Recommendation on pre-contractual information to be given to consumers by lenders offering home loans, COM(2001) 477, 1.3.2001. For further information and the text of the Code see http://ec.europa.eu/internal_market/finservices-retail/home-loans/code_en.htm.

5 See http://ec.europa.eu/internal_market/finservices-retail/docs/home-loans/agreement_en.pdf.

6 See http://eur-lex.europa.eu/LexUriServ/site/en/oj/2001/l_069/l_06920010310en00250029.pdf.

7 Review of the Code of Conduct, initiated by the Commission: *Monitoring the Update and Effectiveness of the Voluntary Code of Conduct on Pre-Contractual Information for Home Loans*, Institute for Financial Services, 17.6.2003. For further information see http://ec.europa.eu/internal_market/finservices-retail/docs/home-loans/home-loans-final-report_en.pdf.

8 *Joint Industry Response to the IFF-Report on the Implementation of the Code of Conduct for Home Loans*, European banking industry, 31.10.2003. For further information see http://ec.europa.eu/internal_market/finservices-retail/docs/home-loans/response-to-iff-report_en.pdf.

9 *European Agreement on a Voluntary Code of Conduct on Pre-contractual Information for Home Loans: Second Progress Report on Implementation in the European Union*, European Banking Industry Committee, 13.12.2005, http://www.eubic.org/Position%20papers/Final%20Progress%20Report%20Clean%20-%20December%202005.pdf.

10 A register of institutions adhering to the Code of Conduct on Pre-contractual Information for Home Loans is available at http://ec.europa.eu/internal_market/finservices-retail/home-loans/code_en.htm.

existing, agreed by the creditor and the borrower.[11] For mortgage credit, there is currently no European legislation harmonising the methodology for calculating the Annual Percentage Rate of Charge and the cost elements which enter into the calculation, as there is, for instance, in the field of consumer credit.[12]

With regard to the calculation methodology, some Member States apply the calculation method for consumer credit as outlined in the Council Directive 87/102/EEC also on mortgage credit. However, since there is no harmonised European calculation method for mortgage credit, Member States may also apply a different methodology.

Regarding the cost elements entering into the calculation, two issues should be considered when assessing which elements are taken into account: who the costs are paid to and whether they are directly related to the credit or not. A consumer has to pay a range of different costs when taking out a mortgage loan. The possible costs range from elements which are levied by the mortgage lender for his own benefit (e.g. the basic interest rate itself, commissions and other kinds of fees which the consumer has to pay in connection with the credit agreement) to cost elements, which are paid to third parties (e.g. insurance premiums, notary costs or taxes). Not all of those services in connection with the credit agreement are legally compulsory for obtaining the credit. Some costs, usually related to ancillary services such as insurance premiums or the cost of maintaining a bank account, might arise for the consumer because the mortgage lender requires the conclusion of certain services for offering the credit at a special rate. Against this background, the Annual Percentage Rate of Charge can be calculated on a narrow basis (so-called narrow Annual Percentage Rate of Charge), meaning that only those costs, which are payable to the mortgage lender and levied for its interest are included, or on a wide basis (so-called wide Annual Percentage Rate of Charge) including other cost elements, e.g. costs which are payable to third parties.

The cost elements, which enter into the calculation base of the Annual Percentage Rate of Charge, vary between Member States. In some Member States, such as Ireland and Sweden, the narrow Annual Percentage Rate of Charge applies, meaning that only those costs, which are payable to the mortgage lender and levied for its own interest, are included in the calculation basis. Other Member States require the inclusion of more cost elements in the calculation basis. For instance, in Germany and Latvia, costs for a compulsory insurance in case of hardship[13] have to be included. In the Czech Republic and Portugal, costs for all compulsory insurance are incorporated and in the United Kingdom, the costs for legal work necessary to obtain the loan are integrated.

1.1.2. Problem description

A market relies on the availability of information to function efficiently and competitively. According to research by the European Commission[14], information provided to retail banking customers may be inadequate or complex, making it difficult to compare prices and choose between banks. This can distort the market.

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11 Article 1(a) of Directive 87/102/EEC as last amended by Directive 98/7/EC, which is currently reviewed.

12 Directive 87/102/EEC as last amended by Directive 98/7/EC.

13 Hardship refers to unforeseen circumstances, for example, death, illness or unemployment of the borrower.

14 *Report on the retail banking sector inquiry*, SEC(2007) 106, European Commission, 31.1.2007, p. 77.

Insufficient, complex or non-comparable information can also impact on the level of consumer mobility in a market by reducing transparency, in particular price transparency, and subsequently competition. Inadequate information can also create uncertainties for consumers thereby reducing their confidence and thus further deterring mobility. The need for correct and sufficient information is even more pronounced in a cross-border context. Unless consumers feel confident about the level of information they receive in other EU Member States, they are unlikely to actively seek cross-border engagements.

Against this background, the information currently provided to consumers on mortgage credit is unsatisfactory for several reasons: incomplete information, lack of EU wide comparability, and differences in the timing of providing the European Standardised Information Sheet to the consumer. These factors can also raise the cost of doing business in another Member State for mortgage lenders.

1.1.2.1. Insufficient and complex information

Evidence collected by the European Commission during its consultation process appears to indicate that the information currently provided to European consumers is insufficient in two ways: consumers do not necessarily have all the information that they require in order to make a decision and even if consumers do have the relevant information, they do not necessarily understand it.

While supporting the usefulness of the European Standardised Information Sheet, during the Forum Group on Mortgage Credit, European consumer organisations underlined the importance of broadening the scope of its information.[15] Research by some Member States, such as the UK, also indicated that the European Standardised Information Sheet might not contain all the necessary information a consumer might need.[16] These findings were also supported in the contributions to the Green Paper consultation, which presented several proposals for additional information, for example on foreign currency loans, to be included in the information to consumers.

The Mortgage Industry and Consumer Dialogue considered possible modifications of the Code of Conduct. Although a final agreement on a revised European Standardised Information Sheet was not reached, progress was made on certain items. A consensus began to emerge on possible changes to some existing ESIS items like 'Description of Product' and 'Amount and currency'. In general terms, the idea of 'risk warnings' was also received rather positively.

According to a Eurobarometer survey from 2005, 59% of EU citizens surveyed felt that it was difficult to understand the information given by financial institutions about the way their mortgages work and the risks involved, ranging from 30% of consumers in Latvia and 33% in Malta to 67% in Germany and France and 76% in Hungary.[17] Furthermore, research in

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15 *The Integration of EU Mortgage Credit Markets*, Report by the Forum Group on Mortgage Credit, December 2004, p. 16.

16 *The Draft Mortgage Sourcebook, including Policy Statement on CP 70*, Consultation Paper 98, UK Financial Services Authority, http://www.fsa.gov.uk/pubs/cp/cp98.pdf, June 2001, p. 61 for instance specific risk and features associated with foreign currency, shared appreciation and deferred interest rate mortgages.

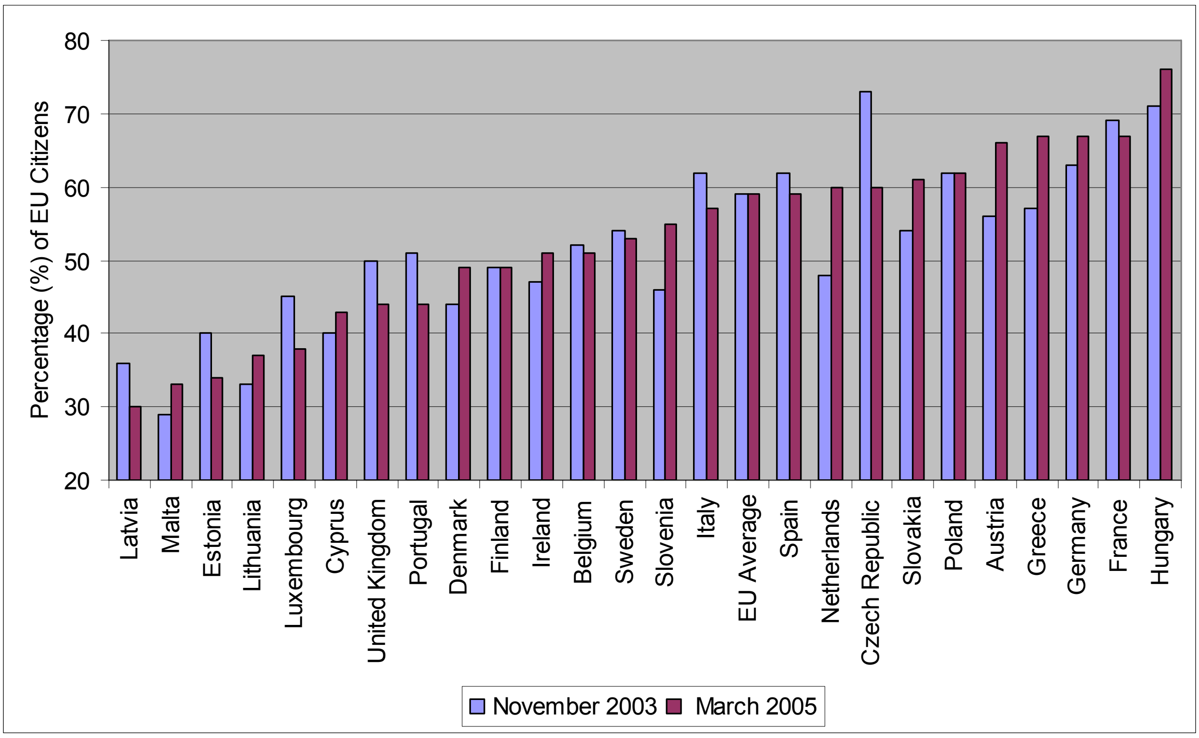
17 *Public Opinion in Europe on Financial Services*, Special Eurobarometer 230, August 2005, pp. 67 and 69 and annex (Q11.4).

the UK showed that UK consumers felt that the language used in the European Standardised Information Sheet was difficult to understand and overly technical for the average consumer.[18]

Consumer confusion may be further compounded by the use of or misunderstanding of certain technical terms. Many consumers base their decision on the price of the mortgage and the Annual Percentage Rate of Charge is often seen by consumers as representing the actual price of the mortgage. However, the fact that different cost bases exist for the Annual Percentage Rate of Charge mean that the price represented differs. This is confusing for consumers, who would expect the Annual Percentage Rate of Charge to represent the costs to be incurred. For example, consumers seeking offers cross-border may be attracted by a lower Annual Percentage Rates of Charge. In reality, it may not be lower but just appear to be so because only a limited range of cost elements are included.

Insufficient information as well as information that is complex and overly technical can inhibit consumer's ability to understand and to use the information provided, limiting consumer confidence and dissuading mobility. Although true at the domestic level, this is even truer for those consumers who do shop around cross-border. For example, the existence of Annual Percentage Rates of Charge which are based on different cost bases can be, at best, confusing or, at worst, misleading thus damaging consumer confidence in the single market.

Graph 1: Percentage of people who find it difficult to understand the information given by financial institutions about the way their mortgages work and the risks involved



Source: *Public Opinion in Europe: Financial Services*, Special Eurobarometer 203, August 2005

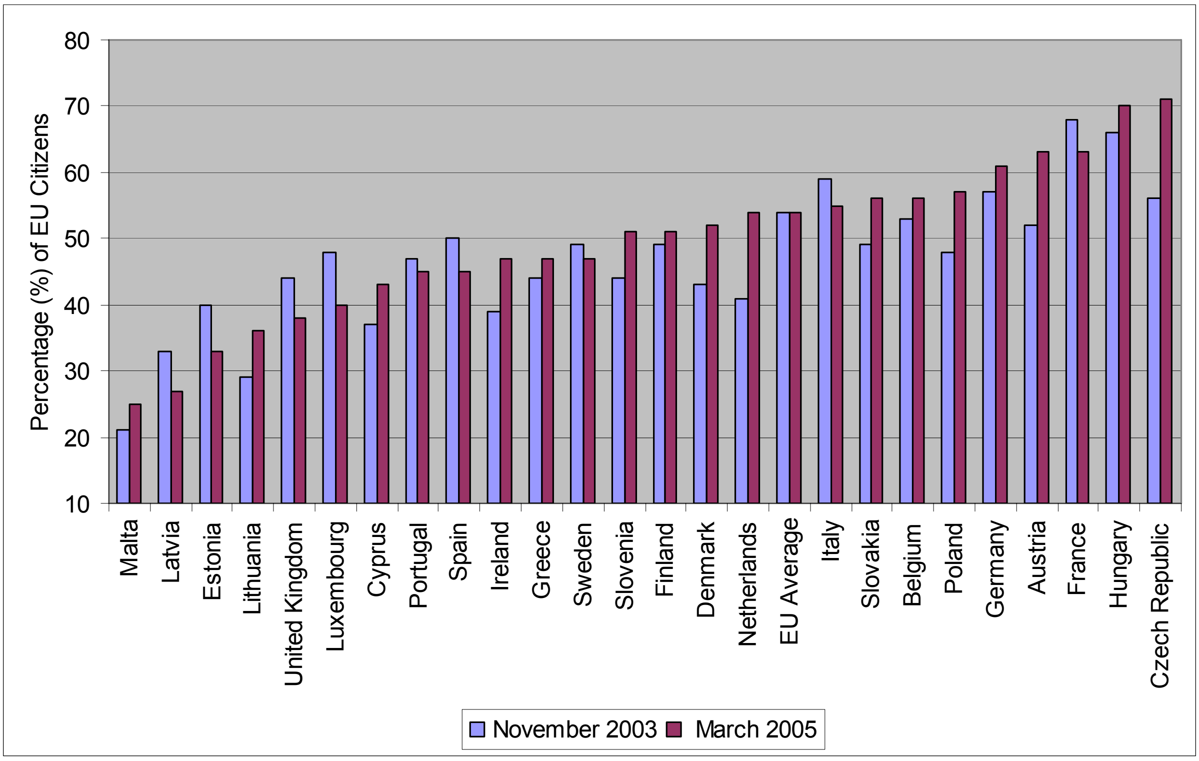
18 Cf. footnote 16, June 2001, Annex A, p. 16.

1.1.2.2. Lack of EU-wide comparability

Comparability is a key tool to better address consumer needs and is indispensable for the decision making-process of consumers. The need for comparability is even more pronounced for mortgage credit than for other products due to the complexity of mortgage products and the lack of familiarity of the different product features from the consumer's point of view. High quality comparable information can help promote consumer confidence and mobility by increasing the transparency of mortgage credit offers and reducing the time and effort to search for alternative providers thereby increasing the potential for customer mobility.

Despite the existence of the Code, which was designed to provide all European mortgage borrowers with standardised pre-contractual information, a 2005 survey found that a majority of EU citizens (54%) still find it difficult comparing information with regards to mortgages.[19] This figure masks however large differences at the national level (see Graph 2 below).

Graph 2: Percentage of people who find comparing information about different mortgages difficult



Source: *Public Opinion in Europe: Financial Services*, Special Eurobarometer 203, August 2005

Although progress has been made since the adoption of the Code of Conduct in 2001, the comparability of information on mortgage products is hindered in two ways: incomplete adherence to the Code of Conduct and a lack of comparability of the information contained therein, in particular the Annual Percentage Rate of Charge.

First, incomplete compliance on the part of mortgage lenders to the Code means that consumers purchasing a mortgage credit product do not necessarily always receive the European Standardised Information Sheet. Although the low level of compliance amongst

19 Cf. footnote 17, p. 67 and annex (Q11.5).

new Member States is, to a certain extent, understandable given the ongoing consultations on the future Commission mortgage credit policy, some EU15 markets have limited adherence and other markets have not subscribed to the Code at all. In the UK, for example, the Financial Services Authority requires mortgage lenders to provider customers with a 'Key Facts Illustration', the format of which is strictly prescribed. The Financial Services Authority considers that the Key Facts Illustration meets the requirements of the European Standardised Information Sheet, albeit in a different format.[20] In Spain, no mortgage lender has subscribed to the Code due to incompatibilities between national law and the Code.[21] In France implementation of the Code is well below 100%, while in some other countries like Belgium, Luxembourg and Sweden implementation of the Code is around 90%.[22] As a consequence, consumers shopping around for mortgage credit offers – even domestically – may be provided with a range of information, some of which may be in line with the Code and some of which may not.

An increasing number of consumers take out their mortgage via intermediaries. For example, in the UK, almost 60% of mortgages are sold via intermediaries.[23] At present, however, there is no obligation for intermediaries to comply with the Code. Although some mortgage lenders complying with the Code may require intermediaries to do so too, consumers taking out a mortgage credit via an intermediary do not necessarily always receive the European Standardised Information Sheet. The Commission has commissioned a study on credit intermediaries in order to establish a comprehensive overview of credit intermediaries operating in the internal market.[24] One of the objectives in this respect is to clarify whether and to what extent credit intermediaries are subject to a legal framework, for instance with regard to information requirements. Results from this study are expected by the end of 2008.

Second, a comparison of offers from different Member States is currently difficult due to the different regimes for the cost base and methodology for the Annual Percentage Rate of Charge. For instance, the Annual Percentage Rate of Charge would be – all other parameters being equal – higher in Member States where certain insurance premiums have to be included in the cost base, than in those where it is not mandatory to include the cost of insurance. In order to exercise a rational decision for the best and most cost-effective product, a consumer would therefore have to compare the different regimes in terms of which cost elements enter the calculation base.

The existence of different national requirements for pre-contractual information and the calculation of the Annual Percentage Rate of Charge also mean that mortgage lenders, seeking to do business in more than one Member State face additional costs. The costs of developing additional IT systems and producing different information materials in accordance with differing Member State requirements can limit economies of scale and scope, thus deterring mortgage lenders from engaging in cross-border activity.

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20 Cf. footnote 9.

21 Cf. footnote 9.

22 Cf. footnote 9.

23 *Mortgage Product Sales Data Trends Report*, UK Financial Services Authority, June 2007, p. 2. For further information see http://www.fsa.gov.uk/pages/Doing/Regulated/Returns/psd/pdf/mortgagetrends_jun07.pdf.

24 Study on credit intermediaries in the internal market (call for tender: 2007/S 145-179463). See http://ted.europa.eu/Exec;jsessionid=35C71FF4EC28076ACD8AE538E06A1AEE.instance_2?DataFlow=ShowPage.dfl&Template=TED/N_one_result_detail_curr.htm&docnumber=179463-2007&docId=179463-2007&StatLang=EN.

The inability to make accurate and meaningful comparisons between offers from local and foreign mortgage lenders would deter consumers from shopping around cross-border because real comparisons between the price of domestic and foreign mortgage products are not possible, therefore providing no incentive for consumers to shop cross-border for the best and most cost-effective product. This situation also creates an unequal playing field for mortgage lenders as some have taken the time and put in financial resources in order to comply with the Code while others have not.

1.1.2.3. Differences in the timing of providing pre-contractual information

The Code does not specify when pre-contractual information has to be given to the consumers. However, in order for consumers to be in a position to compare offers, the information has to be provided at a moment when the consumer is still able to shop around.

The 2003 review highlighted how differences amongst Member States in the moment at which the European Standardised Information Sheet is handed to the consumer could lead to different results when monitoring implementation. In some Member States, such as Belgium, Denmark, France, Ireland, the Netherlands and Austria, the European Standardised Information Sheet is generally handed over together with a binding offer while in other Member States, such as Cyprus, Finland, Luxembourg and Sweden, the European Standardised Information Sheet is provided in advance of a binding offer.

1.1.2.4. Lack of credible monitoring and enforcement mechanisms

The monitoring mechanisms foreseen in the agreement on the Code have been disputed by both sides. Consumer representatives, who have strong reservations about the efficiency of Codes of Conduct in general, have repeatedly questioned the implementation of the Code by mortgage lenders and have criticised the absence of credible enforcement mechanisms. Mortgage lenders questioned the outcome of the 2003 review of the implementation of the Code initiated by the Commission and have argued that mortgage lender's own internal compliance mechanisms were sufficient.

The lack of confidence of both consumers and mortgage lenders in the monitoring and enforcement mechanisms set out in the Code itself is therefore a problem. For consumers this damages consumer confidence in the Code. For mortgage lenders, this may create a reluctance to adhere to and enforce the Code.

Table 1: Problems and consequences

Problems	Consequences
Information: ▪ Incomplete information ▪ Lack of EU-wide comparability ▪ Differences in the timing of providing pre-contractual information ▪ Lack of credible monitoring and enforcement mechanisms on the Code of Conduct	Consumers are unable to obtain complete and comparable information on mortgage credit products. This implies: – Difficulty in comparing prices – Reduced customer mobility – Low consumer confidence => Competition is limited.

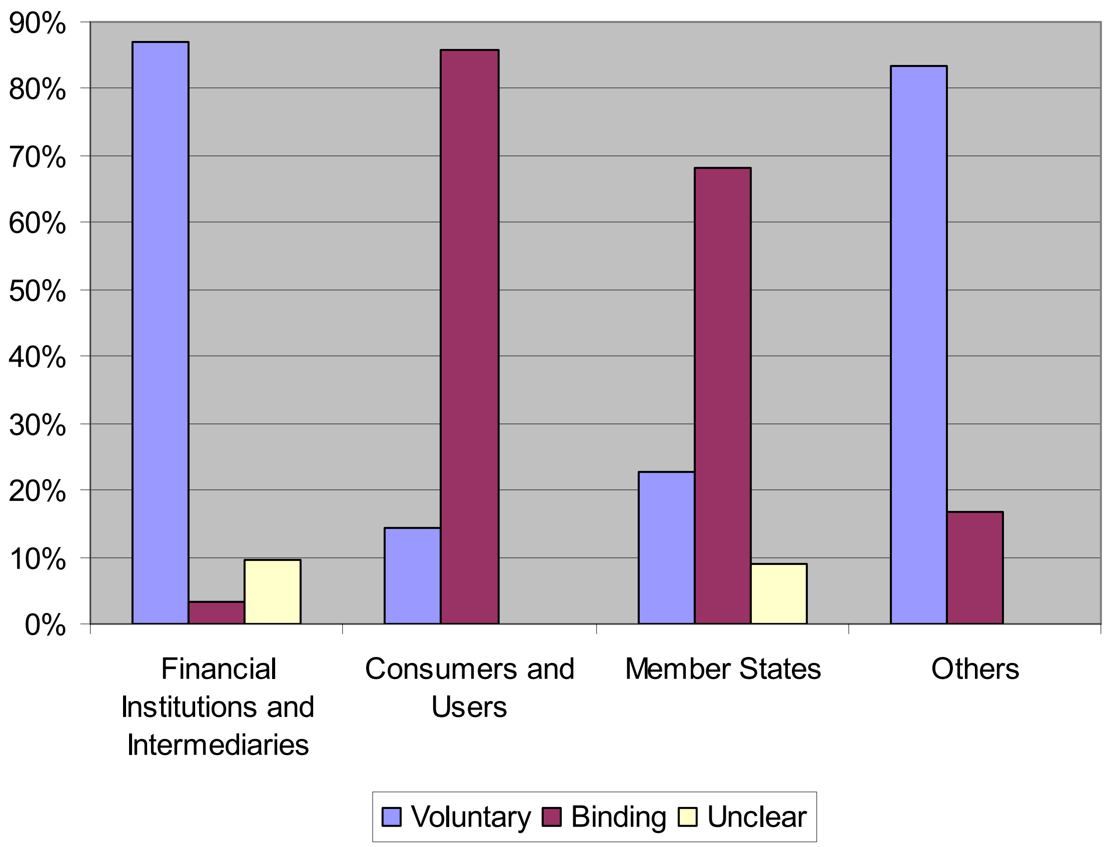
	Mortgage lenders operating cross-border need to comply with more than one set of pre-contractual information and Annual Percentage Rate of Charge requirements. This implies: – Duplication of resources – Unexploited economies of scale => Higher costs for mortgage lenders.

1.1.3. Stakeholder's views

1.1.3.1. Consumers

The majority of consumers support the introduction of binding legislation in the area of pre-contractual information, i.e. replacing the existing voluntary Code of Conduct by legislation, due to insufficient implementation of the Code by mortgage lenders and the absence of credible enforcement mechanisms.[25]

Graph 3: Should the Code of Conduct be replaced by binding legislation or remain voluntary?



Source: *Feedback on the Consultation on the Green Paper on Mortgage Credit*, 23.5.2006, p. 10.

[25] See *Final Report of the Mortgage Industry and Consumer Dialogue*, 20.12.2006, p. 5, http://ec.europa.eu/internal_market/finservices-retail/docs/home-loans/miceg/final_report-en.pdf and *Feedback on the Consultation on the Green Paper on Mortgage Credit*, 23.5.2006, p. 10, http://ec.europa.eu/internal_market/finservices-retail/docs/home-loans/feedback_gp-en.pdf.

Consumers also emphasise the need to improve the content of the European Standardised Information Sheet.[26] With regard to the moment at which the European Standardised Information Sheet should be handed to consumers, consumers are of the opinion that the European Standardised Information Sheet should be given without undue delay after the consumer has given the necessary personal information and, in any event, before the conclusion of the contract, enabling the consumer to use the information contained in the European Standardised Information Sheet in order to compare the offers available on the market, to assess the implications of the product considered and to take a decision.[27] The majority of consumers were of the view that the notion of 'sufficient time' should mean at least 14 calendar days, under which consumers would have the option to sign at any given time without having to wait for the 14 days' period to elapse.[28]

Consumers are in favour of harmonising the Annual Percentage Rate of Charge both in terms of methodology and cost basis at the European level.[29] They support a wide cost basis, i.e. including all costs that the consumer has to pay in connection with the credit, including, for instance, notary costs and taxes.[30] Only those costs which are truly optional for the consumer could be excluded.

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26 See *Final Report of the Mortgage Industry and Consumer Dialogue*, 20.12.2006, p. 4, http://ec.europa.eu/internal_market/finservices-retail/docs/home-loans/miceg/final_report-en.pdf and *Feedback on the Consultation on the Green Paper on Mortgage Credit*, 23.5.2006, p. 11, http://ec.europa.eu/internal_market/finservices-retail/docs/home-loans/feedback_gp-en.pdf

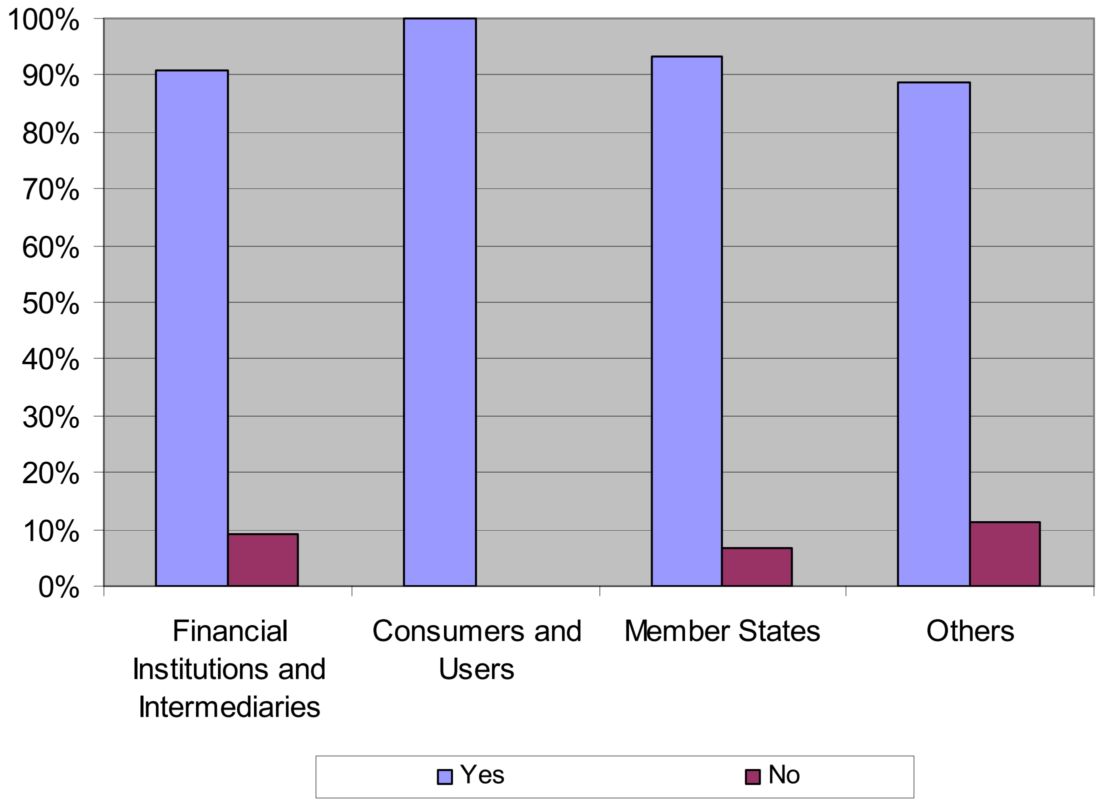
27 See *Final Report of the Mortgage Industry and Consumer Dialogue*, 20.12.2006, p. 2, http://ec.europa.eu/internal_market/finservices-retail/docs/home-loans/miceg/final_report-en.pdf.

28 Cf. footnote 27, p. 3.

29 Cf. footnote 27, p. 10 and *Feedback on the Consultation on the Green Paper on Mortgage Credit*, 23.5.2006, p. 23, http://ec.europa.eu/internal_market/finservices-retail/docs/home-loans/feedback_gp-en.pdf

30 Cf. footnote 27, p. 10.

Graph 4: Should the APR be harmonised?



Source: *Feedback on the Consultation on the Green Paper on Mortgage Credit*, 23.5.2006, p. 22.

1.1.3.2. Mortgage lenders

The majority of mortgage lenders are opposed to the introduction of any binding legislation and considers that the European Standardised Information Sheet in its current form is well designed and balanced.[31] With regard to the moment at which the ESIS is provided to consumers, mortgage lenders agree that the European Standardised Information Sheet should be given without undue delay after the consumer has given the necessary personal information and, in any event, before the conclusion of the contract, enabling the consumer to use the information contained in the European Standardised Information Sheet in order to compare the offers available on the market, to assess the implications of the product considered and to take a decision. However, industry is not in favour of an introduction of a 14-day period as suggested by consumers.[32]

The majority of mortgage lenders are – like consumers – also in favour of harmonising the Annual Percentage Rate of Charge both in terms of methodology and cost basis at the European level.[33] However, mortgage lenders support a narrow cost basis, arguing that only

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31 Cf. footnote 27, p. 10.

32 Cf. footnote 27, p. 3.

33 Cf. footnote 27, p. 10 and *Feedback on the Consultation on the Green Paper on Mortgage Credit*, 23.5.2006, p. 23, http://ec.europa.eu/internal_market/finservices-retail/docs/home-loans/feedback_gp-en.pdf.

those costs levied by the lender for the loan for his own benefit should be taken into account when calculating the Annual Percentage Rate of Charge.[34]

1.1.3.3. Member States

Member States are divided in their views as to whether the Code should be replaced by binding legislation with a majority of supporting the introduction of binding legislation (see Graph 3).[35]

With regard to a harmonisation of the Annual Percentage Rate of Charge on the European level, the vast majority of Member States support the need for a harmonised Annual Percentage Rate of Charge both in terms of the methodology used to calculate it and the costs base (see Graph 4).[36] Member States are more divided in their views as to which cost elements should be taken into account with a majority of Member States supporting – as mortgage lending industry – a narrow definition.[37]

1.1.4. Objectives

Correct, complete, comparable and comprehensible information helps consumers to understand the key features of a financial product, including the risks and costs, in order to enable them to choose the best product for their needs. Addressing the problems of asymmetric information and empowering consumers to be able to make their own decisions will enable consumers to begin to reap the benefits of a single market for mortgage credit.

Specifically, it should be ensured that:

- consumers are provided with correct, complete and understandable information to enable them to assess the implications of the product and take a decision;
- the information provided is comparable across the EU;
- the information is provided at the right moment for consumers to be able to compare the offers available on the market;
- mortgage lenders operating cross-border do not need to comply with heterogeneous sets of information requirements.

1.1.5. Description of options

1.1.5.1. Option 1: Do nothing

Doing nothing would mean that all the problems identified remain. Consumers would continue to receive incomplete information that is difficult to understand and not fully comparable across EU. The information would continue to be provided at different times. Customer mobility would remain impaired and costly. Consumer confidence would remain weak and could even deteriorate.

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34 Cf. footnote 27, p. 10.

35 See *Feedback on the Consultation on the Green Paper on Mortgage Credit*, 23.5.2006, p. 10, http://ec.europa.eu/internal_market/finservices-retail/docs/home-loans/feedback_gp-en.pdf.

36 Cf. footnote 35, p. 23.

37 Cf. footnote 35, p. 24.

There would be no level playing field between mortgage lenders who have invested time and resources to implement the Code of Conduct and those who have not done so. Multiple sets of information requirements would continue to exist. Mortgage lenders would remain subject to a range of different information requirements across Europe reducing the scope for economies of scale and scope when engaging in cross-border activity.

Consequently, this option can be disregarded at this stage.

1.1.5.2. Option 2: Modification of the Code of Conduct

The problems with the current content and format of the Code of Conduct may be addressed by amending the existing Code of Conduct. The Mortgage Industry and Consumer Dialogue could be re-convened with a mandate to finalise its work done so far modifying the Code in order to ensure that consumers are provided with all the relevant information in a clear and comparable format. Modifications of the Code could also be made to ensure that the information is provided at a moment where consumers are able to compare different offers. However, for self-regulation to be successful, adherence to and implementation of the Code would have to be substantially improved. The Mortgage Industry and Consumer Dialogue could be tasked with agreeing on proposals to ensure credible and independent monitoring and enforcement of the Code.

In principle, in order to ensure that all consumers taking out a mortgage credit receive the same information, in particular the European Standardised Information Sheet, no matter what the point-of-sale, credit intermediaries could also be invited to participate in the Dialogue negotiations with the view to encouraging credit intermediaries to subscribe to the Code. However, as stated above, the Commission is currently undertaking a study on credit intermediaries. Any decision as to whether intermediaries should be also party to the Code appears therefore to be premature.

1.1.5.3. Option 3: Legislation

The Code of Conduct could be converted into binding legislation. In order to ensure that consumers receive all the relevant information to enable them to assess the implications of the product and take a decision, the Commission could engage in a thorough evaluation of the all information contained in the Code and the format in which it is presented and, on the basis of comprehensive consumer testing, could propose a legally binding European Standardised Information Sheet.

In principle, credit intermediaries could also be subject to any binding information requirement. However, in the light of the ongoing study, such a decision appears to be premature at this point in time.

1.1.6. Impact assessment

1.1.6.1. Option 2: Modification of the Code of Conduct

As such, self-regulation could be a means of ensuring that consumers are provided with all the relevant information at the right moment.

One of the stated benefits of self-regulation is that it is flexible and may be easily modified to take into account market developments. The problems with the current content and format of the Code of Conduct as well as the moment at which the European Standardised Information

Sheet is provided may be addressed by amending the existing Code of Conduct. Amendments to the Code could ensure that consumers receive all the relevant information to enable them to compare the offers available as well as assess the implications of the product and take a decision. If an agreement to modify the Code is reached by the Mortgage Industry and Consumer Dialogue, it could be immediately applicable to those organisations who have subscribed to it, quickly bringing the benefits of the modifications to consumers and mortgage lenders alike. This has the potential to improve consumer confidence.

However, as the Dialogue in 2006 between consumer and mortgage lending industry representatives illustrated, reaching an agreement could potentially be a long and difficult task, thereby neutralising the flexibility of self-regulation to a certain extent. Furthermore, the extent to which any agreement by the Dialogue meets the expectations of European consumers in providing all relevant information in a clear and comparable format would be dependent on the outcome of the negotiations, thereby possibly endangering the provision of optimal information. Furthermore, mortgage lenders who have already subscribed to the Code would face costs in implementing the modifications.

While amending the Code of Conduct to broaden the scope of information and to change its format would potentially solve the problem of incomplete information, it would be insufficient to completely solve the lack of comparability for several reasons. First, the Annual Percentage Rate of Charge would remain regulated by law at the national level and, given its different methodologies and cost bases, would remain difficult to compare across Europe. This cannot be addressed through self-regulation. Second, adherence to and implementation of the Code would have to be substantially improved. Credible and independent monitoring and enforcement mechanisms would need to be established. The Mortgage Industry and Consumer Dialogue could be tasked with agreeing on proposals to ensure proper enforcement of the Code. However, the voluntary nature of the Code implies that mortgage lenders cannot be obliged to subscribe to and implement the Code. The persistent lack of comparability would mean that customer mobility remains impaired as the search costs associated with comparing information would remain high.

Furthermore, self-regulation would not alter the current situation whereby mortgage lenders face additional national legal information requirements. Mortgage lenders operating cross-border would therefore continue to be subject to heterogeneous sets of information requirements and would continue to face the associated costs.

Mortgage lenders complying with the Code would face the costs of implementing the changes to the Code whereas those who do not comply avoid such costs.

Table 2: Impacts of Option 2

Option	Affected parties Direct impact (D) Indirect impact (I)	Impacts ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	Timing One-off Short-term Medium-term Long-term	Nature Dynamic Static	Likelihood Certain High Medium Low
Modification of the Code of Conduct	Consumers (D+I)	+/++ receiving correct, complete and understandable information (D) ≈ information not necessarily comparable (APRC) (D) +/++ receiving information at the right moment (D) ≈/+ ↑ mobility (I)	Medium term	Dynamic	Medium (depending willingness of parties to engage in Dialogue and on compliance by mortgage lenders)
	Mortgage lenders (D+I)	– ↑ cost for implementing changes to the Code (D) ≈ cost for possibly complying with heterogeneous sets of information requirements (I) –/≈ distorted level playing field (D)	Medium term	Dynamic	Medium (depending result of Dialogue and on compliance by mortgage lenders)
	Intermediaries (D+I)	– ↑ cost for implementing changes to the Code (D) ≈ cost for possibly complying with heterogeneous sets of information requirements (I) –/≈ distorted level playing field (D)	Medium term	Dynamic	Medium (if covered by the Code)
	Member States	≈	n.a.	n.a.	Certain

1.1.6.2. Option 3: Legislation

A revised and legally binding European Standardised Information Sheet could be proposed, thereby ensuring that all EU consumers are provided with all the relevant information at the same and right moment. Proper consumer testing would be carried out to ensure that the standards meet with consumers' needs and expectations. However, the eventual extent to which any binding information requirements meet the needs of consumers would also be dependent on the outcome of the co-decision process.

Binding legislation could also improve the degree of comparability by ensuring that the information provided to consumers, including the Annual Percentage Rate of Charge, is comparable across the EU. By making pre-contractual information requirements and the Annual Percentage Rate of Charge binding, a level playing field would be established for consumers and industry alike, creating the right environment for enhanced competition. Whether the adoption of binding legislation would completely remove the obligation for mortgage lenders to comply with additional national legal requirements, would largely depend on the final wording of the text.

The adoption of binding legislation would entail costs for several stakeholders. Mortgage lenders who have already adopted the Code would need to modify their European Standardised Information Sheet to take into account any changes. Mortgage lenders who do not yet comply with the Code would be required to do so thereby incurring the administrative costs of implementing the relevant measures. Assuming that any measure adopted would help reduce the multiplicity of information requirements across Europe, mortgage lenders operating cross-border would achieve administrative cost savings as the need to comply with heterogeneous information would be reduced. The net impact in terms of costs on mortgage lenders of the adoption of binding legislation is however difficult to clearly establish at this stage. Member States would face costs for implementing the EU legislation because they would have to adapt their national systems to the new legislation. The amount of those costs would depend largely on the compatibility of the EU legislation with existing national laws.

Table 3: Impacts of Option 3

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Legislation	Consumers (D+I)	+/++ receiving correct, complete and understandable information (D) +/++ receiving comparable information (including on APRC) (D) +/++ receiving information at the right moment (D) + ↑ mobility (I)	Medium to long term	Dynamic	Medium
	Mortgage lenders (D+I)	? overall costs: => ↑ cost for adapting to and complying with new information requirements) (D) => ↓ cost for complying with heterogeneous sets of information requirements (I) + ↑ level playing field between mortgage lenders (D)	Medium to long term	Dynamic	Medium
	Intermediaries (D+I)	? overall costs: => ↑ cost for adapting to and complying with new information requirements) (D) => ↓ cost for complying with heterogeneous sets of information	Medium to long term	Dynamic	Medium (if covered by legislation)

		requirements (I) + ↑ level playing field (D)			
	Member States (D)	–/– – ↑ Cost for introduction/amendment of legislation (D)	Medium to long term	Static	Certain

1.1.7. Comparison of options

Option 1 would not require any action by EU. Member States would continue to develop information requirements for mortgage credit at the national level. Inconsistencies between domestic legislation and the European Code of Conduct would – depending on the position of Member States – also most likely prevail and banks seeking to adhere to the Code would continue to face additional costs in complying with the Code and Member State legislation.

A choice for Option 2 would represent an important signal as to the future credibility of self-regulation in the field of retail financial services. Potentially, self-regulation could offer a quick and easy solution. However the reality is that negotiations are likely to be extremely resource consuming for consumer and mortgage lender representatives. Given their shortage of resources, this problem is likely to be particularly acute for consumer representatives. In addition, consumer representatives have expressed on several occasions that they have lost faith in the Code of Conduct and might therefore refuse to engage in further negotiations. Likewise, a decision for Option 3 would require some time. The necessary process including comprehensive consumer testing and the legislative process would mean that any changes would not enter into effect for several years. The adoption of Option 3 would however ensure a consistent framework with other products such as consumer credit, investment services and insurance products which have legally binding information requirements at the EU level.

The key difference between Options 2 and 3 is that self-regulation cannot completely ensure the comparability of information between Member States, whereas binding legislation can. For Option 2 to be a success, adherence to and implementation of the Code would have to be substantially improved to the extent that it is of a similar level to binding legislation. Credible and independent monitoring and enforcement mechanisms, which are likely to be complex and controversial, would also need to be established. However, even then Option 2 would not be able to ensure that the Annual Percentage Rate of Charge is comparable across Europe.

In conclusion, both self-regulation and binding legislation have the potential to bring the desired results in terms of providing consumers with the right information at the right time. Both initiatives would require time to be worked out and implemented. In terms of the costs, both options would require modifications of the existing European Standardised Information Sheet and thus would entail costs for mortgage lenders. Binding legislation would also entail costs for those mortgage lenders who have not yet complied with the Code. However this must be offset against the benefits for consumers that all mortgage lenders are complying with identical pre-contractual information requirements. Intermediaries which are currently not subject of the Code would also face costs for complying with pre-contractual information requirements. Member States would only face costs under Option 3. Option 3 is however the only solution which would ensure the comparability of the Annual Percentage Rate of Charge. Since the calculation method and the cost base for the calculation for the Annual Percentage Rate of Charge is a separate issue from the provision of pre-contractual information, it could also be considered to legislate only on the calculation method and the cost base for Annual Percentage Rate of Charge, while leaving the provision of pre-contractual information to self-regulation (combination of Options 2 and 3).

Table 4: Overview of policy option effectiveness

Option		Specific objectives: Information is correct, complete and understandable	Specific objectives: Information is comparable	Specific objectives: Information is provided at the right time.	Specific objectives: Lenders do not need to comply with heterogeneous sets of information	General objectives: Cross-border activity	General objectives: Product diversity	General objectives: Consumer confidence	General objectives: Consumer mobility	Comments
1	Do nothing	≈	≈	≈	≈	≈	≈	≈	≈	No change.
2	Modification of the Code of Conduct	+/++	≈/+	+	≈	≈	≈	+	≈/+	Final impact would depend on the willingness of parties to reach agreement and what they agree on.
	Pre-contractual information requirements	+/++	≈/+	+	≈	≈	≈	+	≈/+	
	APRC	≈	≈	≈	≈	≈	≈	≈	≈	Modification of the Code would have no impact on the Annual Percentage Rate of Charge.
3	Legislation	+/++	+/++	+	+	+	≈	+/++	+	Final impact would depend on the content of the legislation and the outcome of the co-decision procedure.
	Pre-contractual information requirements	+/++	+/++	+	+	+	≈	+/++	+	
	APRC	+/++	+/++	≈	+	+	≈	+/++	+	

Assessment: ++ = strongly positive; + = positive; – – = strongly negative; – = negative; ≈ = neutral/marginal; ? = uncertain

1.2. Financial education

1.2.1. Context

Numerous international surveys have demonstrated a low level of understanding of financial matters on the part of consumers.[38] There is also a strong correlation between low levels of functional literacy and the ability to make appropriate financial decisions. The provision of financial education can deliver benefits not only to the individual, but also to the wider economy and society as a whole. Financially literate citizens are likely to plan better for unexpected changes in circumstance, save more and have lower default rates, and can drive innovation and competition by shopping around for the most appropriate solution for their needs. They are more likely to be engaged with the mainstream financial industry and rely less on higher-cost and higher-risk fringe providers. Although it is difficult to assess the

38 See for example, *Financial Capability in the UK: Establishing a Baseline*, UK Financial Services Authority, March 2006; research by the Irish National Adult Literacy Agency, August 2006 (see http://www.nala.ie/press/pressreleases/20060914161103.html); results of research published by a working group of the Autorité des Marchés Financiers (France), June 2005 (see http://www.amf-france.org/documents/general/6080_1.pdf).

effectiveness of financial education programmes in isolation from the social and economic circumstances of the consumers to whom they are delivered, there are some statistics indicating the positive influence of financial education. For instance, research on the effectiveness of pre-purchase home ownership counselling among lower-income borrowers in the US has found that potential borrowers who receive this counselling prior to purchasing have on average a 13% lower delinquency rate[39].

The European Commission has already taken some initial steps to address the issue of financial education. The first of these is a website that offers consumer education to adults, called Dolceta[40]. This site was initially developed for use by institutions of adult education. One of the modules of this site is dedicated to improving understanding of financial services, at three levels of difficulty. The issues to consider when taking out a home loan are one of the subjects covered. The site is translated into all of the Community languages and the information contained therein is adapted to the specific features and characteristics of each national market.

In the period 2005–2007, the Commission funded two wide-ranging studies on the provision of financial education in EU Member States[41]. It also hosted a conference on the issue in March 2007[42], at which participants expressed their support for the ongoing provision of financial education, starting in schools, and continuing through to accompany the individual's significant life events, including the purchase of a home. The issue of financial education was also raised in the Green Paper on Retail Financial Services[43], prompting a generally positive response from contributors to the consultation on this paper.

1.2.2. Problem description

Consumers are only able to make the most of the single market in financial services if they have the financial literacy to make appropriate decisions for their individual circumstances. Even if consumers are provided with good information, they may be unable to use it properly due to insufficient understanding of financial terms, products and services. In the context of mortgage credit, a low level of financial understanding can have several consequences.

First, low financially literacy can hamper consumer confidence. With a wide range of mortgage products available, it is important that consumers understand the implications of the products that they are offered in order to be able to decide on the best product for their needs. The clearest example of this is the difficulty many consumers experience in understanding the later consequences of choosing between fixed and variable-rate mortgages. Financially less literate consumer are often not in a position to ask the appropriate questions and understand the information provided. Second, a mortgage product which is right for a consumer today might not necessarily be the most appropriate product for their needs after a period of time

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39 *A Little Knowledge Is a Good Thing: Empirical Evidence of the effectiveness of pre-purchase homeownership counselling*, Abdighani Hirad, Peter Zorn, Joint Center for Housing Studies, Harvard University, August 2001, p. 1.

40 Development of On-Line Consumer Education Tools for Adults, www.dolceta.eu.

41 *Financial Education – Essential principles and ways forward*, ASB Schuldnerberatungen GmbH, L'Observatoire du Crédit et de l'Endettement, GP-Forschungsgruppe and SKEF, The Association for Promotion of Financial Education, April 2007 and *Survey of Financial Literacy Schemes in the EU27*, Evers & Jung, November 2007, http://ec.europa.eu/internal_market/finservices-retail/capability/index_en.htm.

42 See http://ec.europa.eu/internal_market/finservices-retail/capability/index_en.htm.

43 *Green Paper on Retail Financial Services in the Single Market*, COM(2007) 226, 30.04.2007.

due to changing financial, personal or economic circumstances. Low levels of financial literacy mean that many consumers may not be able to make allowances for these changing needs, nor be confident enough to switch products by adapting their mortgage to their own changing circumstances. Consequently, low financial literacy can be an impediment to customer mobility. Finally, consumers with low levels of financial literacy are more likely to stay with locally-based providers, and are less likely to have the confidence to shop around for the best product for their needs, regardless of the location of the financial services provider. This means that they would not avail of the opportunities offered by the single market.

Table 5: Problems and consequences

Problems	Consequences
Financial literacy: ▪ Low level of financial literacy	Consumers are unable to understand financial terms, products and services. This implies: – Difficulty in comparing products – Difficulties in understanding consequences of differences in interest rates and terms of loans and the final amount to be paid – Reluctance to switch products and/or providers => reduced customer mobility – Low consumer confidence => Competition is limited.

1.2.3. Objectives

The Commission seeks to ensure that consumers have sufficient financial literacy to understand the information provided to them with regard to mortgage products.

1.2.4. Description of options

1.2.4.1. Option 1: Do nothing

Doing nothing would mean that all the problems identified remain. The provision of financial education in EU Member States would continue to be patchy, with no political pressure on stakeholders to undertake initiatives to improve citizens' financial literacy. Practitioners would continue to operate without knowledge of potential examples of best practice elsewhere, and would not enjoy political support or practical assistance in the organisation of events. Fewer stakeholders would be encouraged to deliver financial education, with the result that the current status quo with regard to citizens' difficulties in understanding key financial products and concepts would remain unchanged. Consumer confidence would therefore remain low and consumers continue to face difficulties in understanding the full implications of the products that they are purchasing. Consumers with a low level of financial education are also less likely to switch providers when a better offer becomes available elsewhere, limiting customer mobility and competition. Likewise, such consumers are less likely to have the confidence to shop around for the best product regardless of the location of the financial services provider.

Consequently, this option can be disregarded.

1.2.4.2. Option 2: Mortgage-specific measures to improve financial literacy

To concentrate on mortgage-specific measures to improve financial literacy would be to discount the context in which they are delivered. The building up of an individual's financial literacy requires an accumulation of knowledge on a wide variety of topics, ranging from basic financial concepts such as the impact of interest rates and inflation to practical issues such as balancing a budget and making provisions for the future. In this context, it is important that financial education is cumulative, starting at an early age and becoming available at moments of particular relevance, including living independently for the first time, becoming parents, and approaching retirement. Of course, buying a home is one of these key moments, but the provision of mortgage-specific financial education in isolation would not be realistic, as the recipients of such specific education would not have the framework of reference to other financial market concepts/ products in order to absorb such information.

This option – either in a binding or non-binding form – would therefore not be of sufficient scope to address the issue at hand.

1.2.4.3. Option 3: Horizontal measures to improve financial literacy

Option 3.1: Non-binding measures

The Commission can play a role in raising awareness of the need to provide financial education. It can also encourage those who are, or could be, involved in the delivery of financial education, including Member State authorities, the financial services sector, consumer agencies and other NGOs, to develop good-quality financial education programmes that are appropriate to the needs of their target audiences.

In this role, the Commission can bring forward non-binding guidelines, and develop initiatives to promote best practices in the EU Member States through a variety of means. These could include giving financial education practitioners the opportunity to exchange experiences through an experts' network; supporting and sponsoring the organisation of events to promote financial education in the Member States; and publishing online reference materials on financial education programmes and research. In addition, the Commission can assist schools to deliver financial education to children through the development of voluntary online tools and support teaching materials on the subject.

Option 3.2: Legislation

Any legislative proposals at Community level must adhere to the principal of subsidiarity. There is no evidence to date that suggests that action at Member State level is not sufficient to achieve the objective of improving citizens' financial literacy. Furthermore, there has been considerable consultation on the Commission's role in the area of financial education. These included the above-mentioned conference on Increasing Financial Capability in March 2007, meetings with Member State representatives, financial services consumer and user groups and with financial services industry representatives. The Commission has also drawn on responses to the questions on financial education in the Green Paper on Retail Financial Services and the comments made on the subject at the Public Hearing on Retail Financial Services. Stakeholder responses have consistently supported the view that financial education is best delivered as close to the target audience as possible, namely at national, regional or local level, and that legislative initiatives would not enjoy wide support. Legislative proposals can therefore also be discarded at this stage.

1.2.5. Impact Assessment

Given that mortgage-related issues should be treated within a wider framework of initiatives to promote financial education in general, horizontal, non-binding measures would be the only realistic and appropriate tool to reach this goal. Financial education can, and should, be delivered by a variety of players, and there is no 'one size fits all' solution that would encapsulate the wide diversity of subjects and target groups involved.

The obtaining of mortgage credit is one of the many key moments in a citizen's life when he is open to, and in need of, financial education. However, it is important that such education be provided in a coherent, consistent way, right through the lifecycle from childhood to retirement. Horizontal measures to deliver lifelong financial education are an appropriate tool towards achieving the aim of empowering citizens to make appropriate financial decisions for their particular circumstances thus improving consumer confidence. More confident consumers are more likely to shop around between providers, regardless of their location. Improving the financial literacy of consumers is therefore likely to lead to increased customer mobility.

From a mortgage lender perspective, financially literate and mobile consumers are likely to lead to the development of more competitive mortgage markets across Europe. This would be driven by demand by more financially literate consumers for innovative mortgage products that meet their expressed needs. Financial education, with its influence on customer willingness to move between providers, may also make it more attractive for mortgage lenders to enter new markets in other Member States, enhancing cross-border activity. Consumers who have received financial education are also less likely to default on their payments, generating greater stability for both lenders and investors.

Given the long-term commitments required to achieve such a level of financial literacy among consumers, financial education will never be able to replace the provision of appropriate information to the consumer, therefore the costs for the delivery of the relevant information will continue to apply to mortgage lenders, intermediaries and independent financial advisers.

In conclusion, both mortgage-specific and more general financial education provision can have benefits in terms of empowering citizens to take appropriate financial decisions for their individual circumstances. However, the inclusion of mortgage-related issues within a more general approach to financial education may be more appropriate. Due to earlier, age-appropriate financial education received, citizens would already have an understanding of basic financial concepts and may have less difficulty in applying these to the choices involved in the purchase of mortgage credit. The degree to which these benefits can be achieved depends very much on the level of commitment shown by Member States and other stakeholders to the delivery of financial education on the ground.

Table 6: Impacts of Option 3.1

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Non-binding measures	Consumers (D+I)	+ purchase a suitable product for their needs (D) + can understand the consequences of their purchasing decisions (D) + may be less likely to default on payments and be subject to foreclosure (I)	Medium to long term	Dynamic	Medium (depending to what extent Member States and other stakeholders deliver high-quality financial education)
	Mortgage lenders (D)	– overall costs: mortgage lenders would be encouraged to develop financial education programmes (D); this may not be rewarded by greater customer loyalty; mortgage lenders would still be required to make the necessary information provision on individual products (D); + financially literate consumers may be willing to reward innovation by choosing creative mortgage products ≈/+ reduced risk of default	Medium to long term	Dynamic	Medium (depending to what extent mortgage lenders engage with financial education provision)
	Member States (D)	–/– – Cost for introduction/ roll-out of financial education initiatives (D)	Medium to long term	Dynamic	Medium
	Investors (I)	≈/+ reduced risk of default	Medium to long term	Dynamic	Medium (depending to what extent Member States and other stakeholders deliver high-quality financial education)

1.2.6. Comparison of options

In view of the above, the only realistic, widely-supported option is to encourage horizontal non-binding measures. This is what the Commission has already announced it would do in the context of the Communication on Financial Education which is due for adoption on 19 December 2007.

Table 7: Overview of policy option effectiveness

Option		Specific objective	General objectives				Comments
		Ensure that consumers have sufficient financial literacy to understand the information provided to them with regard to mortgage products	Cross-border activity	Product diversity	Consumer confidence	Consumer mobility	
3.1	Horizontal non-binding measures	+	≈/+	≈/+	+	+	Dependent on the extent to which implemented by Member States and other stakeholders

Assessment: ++ = strongly positive; + = positive; – – = strongly negative; – = negative; ≈ = neutral/marginal; ? = uncertain

1.2.7. Actions undertaken by the Commission

The Commission is issuing a Communication in which it sets out its role in the area of financial education.[44] In this Communication, the Commission seeks to raise awareness of the importance of financial education and promote best practices. The scope of the actions envisaged in the Communication goes far beyond the scope of mortgage credit policy and has implications for the overall social and economic welfare of consumers.

1.3. Product suitability

1.3.1. Context

Mortgage credits are complex financial products. Despite the economic and financial significance of purchasing a mortgage credit product, neither self-regulation nor binding legislation, even if developed on the basis of comprehensive consumer testing, is able to ensure that all consumers are able to understand the information provided to them due to insufficient financial literacy. However, a consumer must be confident that he purchases the mortgage product best suited for his needs. This is true for every kind of financial service but is even more pronounced for mortgage loan products which are one of the biggest and longest financial commitments a borrower is likely to face in his lifetime.

[44] The Communication on Financial Education is due to be adopted in December 2007.

Against this background, some Member States have rules in place either to ensure that the mortgage lenders sufficiently assess the borrower's creditworthiness and/or to ensure that the consumer can obtain advice on which mortgage credit product to take out.

1.3.1.1. Creditworthiness

The mortgage lender is generally expected to assess the creditworthiness of the consumer in the context of the transaction envisaged.[45] Assessing the creditworthiness of a consumer in this context means that the mortgage lender/intermediary considers all aspects of the borrower's specific situation before offering a range of products to a borrower to choose from. Mortgage lenders can assess the creditworthiness of consumers in several ways. For instance, mortgage lenders can consult a credit register to get information about the credit status of a borrower[46], they can obtain the necessary information directly from the borrower, or they might already have a full picture of the financial circumstances of the borrower because the borrower has a long term financial relationship with them.

In some Member States, specific obligations exist for the mortgage lender to assess the creditworthiness of a borrower. For instance, in Belgium, mortgage lenders are obliged to inform themselves of the consumer's situation and 'to look, amongst the credit contracts they usually offer or for which they usually intervene, for the type and amount of credit best adapted, owing to the financial situation of the consumer at the time the contract is concluded (and to the aim of the credit)'.[47] Belgian law also prohibits the mortgage lender from granting credit if, having regard to the information that it has or should have at its disposal, it considers that the consumer will be unable to repay.[48] In Ireland, mortgage lenders must collect sufficient information from the consumer to enable them to provide a recommendation for a product or service appropriate to that consumer.[49] In the UK, mortgage lenders need to have a written responsible lending policy in place setting out the factors that they will take into account in assessing a customer's ability to repay. Mortgage lenders must also keep an adequate record to demonstrate that they have taken account of the customer's ability to repay.[50]

1.3.1.2. Advice

Providing advice is distinct from providing information. Whilst information merely describes a product (often accompanied by explanations, clarifications and/or risk warnings), advice implies the provision of a recommendation for an individual consumer to opt for a given product, taking into account the individual's specific situation.[51]

Many consumers seek out expert advice before committing themselves to one particular product.

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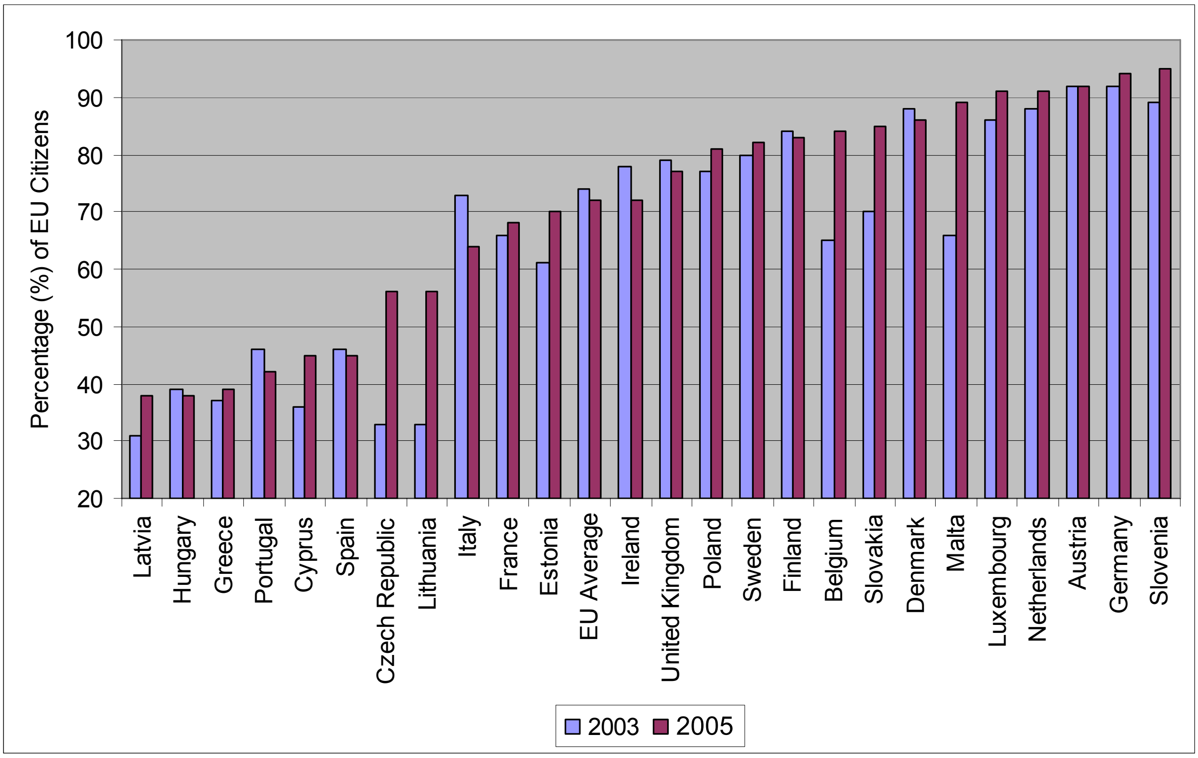
[45] Cf. footnote 27, p. 6.
[46] See for further information regarding the accessibility of credit registers, Section 4. (Credit registers).
[47] Belgian Act of 12.6.1991 concerning consumer credit, Article 11.
[48] Cf. footnote 47, Article 15.
[49] *Consumer Protection Code*, the Irish Financial Regulator, August 2006.
[50] *Mortgage and Home Finance: Conduct of Business Sourcebook*, UK Financial Services Authority, MCOB 11.3 Responsible lending, and responsible financing of home purchase plans, http://fsahandbook.info/FSA/html/handbook/MCOB/11/3.
[51] Cf. footnote 27, p. 6.

According to a Eurobarometer survey from 2005, although 92% of European consumers assert their autonomy when making financial decisions, 72% of consumers expect financial institutions to give them advice (this figure however masks large differences within the EU ranging from 38% in Latvia and Hungary to 95% in Slovenia).[52] Other research in individual Member States confirms that consumers do in fact frequently seek advice when taking out a mortgage credit, for example, in the UK, 71% of mortgage transactions between April 2005 and March 2007 and 93% of all mortgages sold via intermediaries were advised sales.[53]

Graph 5: Percentage of EU citizens who expect financial institutions to give advice

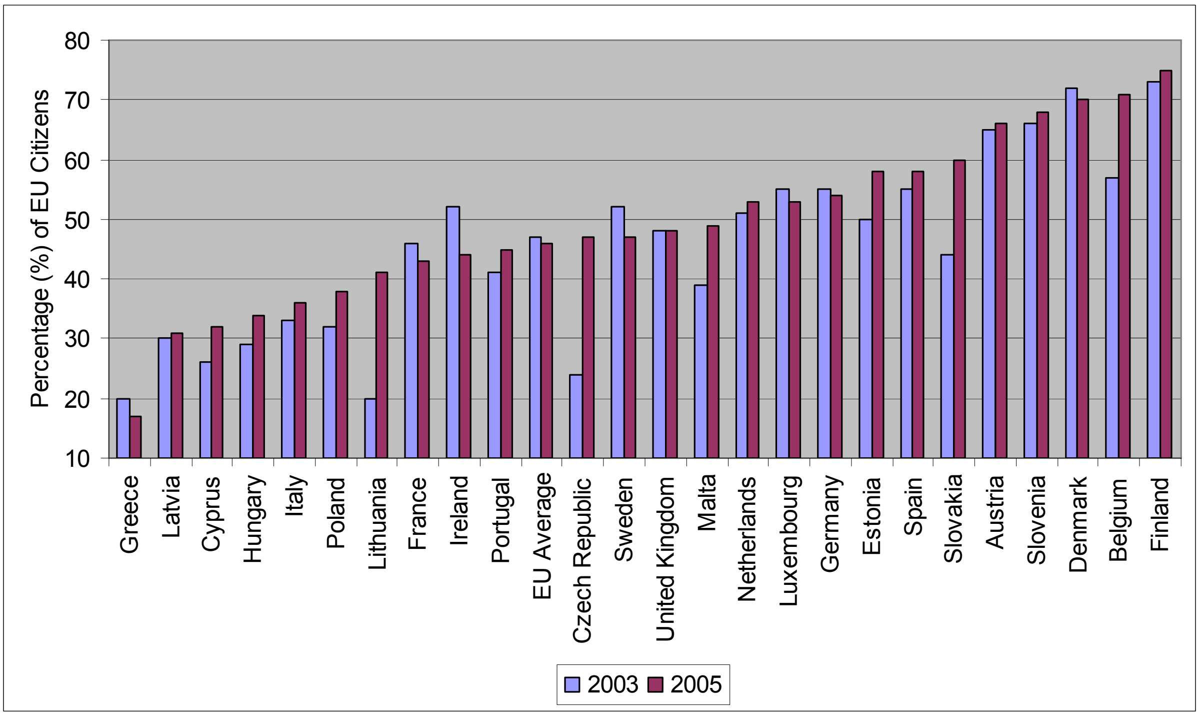


Source: *Public Opinion in Europe: Financial Services*, Special Eurobarometer 230, August 2005

At the same time, less than half (46%) of the consumers surveyed in the Eurobarometer survey actually trust the advice provided by the financial institution, with the figure as low as 17% in Greece.[54]

52 Cf. footnote 17, p. 79.
53 Cf. footnote 23, p. 6.
54 Cf. footnote 17, pp. 79 and 82.

Graph 6: Percentage of EU citizens who trust advice from financial institutions



Source: *Public Opinion in Europe: Financial Services*, Special Eurobarometer 230, August 2005

These figures illustrate that although advice is deemed important by consumers taking out a mortgage credit, at the same time the objectivity of given advice appears regularly to be doubted.

Although there does not appear to be any general legal duty to provide advice on the suitability of the credit offer in any Member State, provisions in a few Member States may have a similar effect. In Denmark, for instance, 'a financial undertaking shall provide advice, if the customer so requests,…'. Furthermore, the same provision foresees that 'the undertaking shall provide advice at its own initiative,…,where circumstances indicate that there is reason to do so'.[55] In Ireland, besides the obligation to collect sufficient information from the consumer, mortgage lenders must also ensure suitability of any offered or recommended product to that consumer and provide a written statement on why the product or a selection of product options offered is suitable to that consumer and the reasons why a recommended product is considered to be the most suitable product for that consumer.[56] However, according to the Irish government, 'these measures are, however, not seen as a substitute for independent advice being provided to consumers, especially those in vulnerable financial circumstances'.[57]

In other countries, although no obligation to advise exists, if advice is provided as a service, then certain standards must be met. In the Netherlands, for example, the financial services provider must take into account the borrower's financial position, knowledge, experience and willingness to take risks, use this information in the provision of advice and explain the considerations underlying the advice, insofar as this is necessary for a proper understanding of

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55 *Executive order on Good Practice for Financial Undertakings*, Executive Order no. 1046 of 27.10.2004, Part 3.

56 Cf. footnote 49.

57 See response of Ireland on the Government Expert Group on Mortgage Credit questionnaire, p. 3, http://ec.europa.eu/internal_market/finservices-retail/docs/home-loans/gegmc/ie_comments-en.pdf.

the advice.[58] In the UK, the advisor should take into account the affordability of the mortgage, understand and reflect on consumer's needs and circumstances, and identify the most suitable mortgage for the individual consumer.[59] In Ireland too, certain general principles such as honesty, fairness, professionalism in the best interests of the customers are, amongst other things, required in all the mortgage lender's dealings with customers.[60]

1.3.2. Problem description

Taking into account the complexity of mortgage credit products, in conjunction with an increasing variety of products, how a borrower chooses a product is becoming increasingly important.

1.3.2.1. Insufficient or incorrect assessment of creditworthiness

One of the reasons why a consumer might not purchase the best product for his needs might be that a mortgage lender is not assessing the credit status correctly, or only insufficiently or not at all. While in some Member States there are already requirements in place for mortgage lenders to assess the creditworthiness of a consumer, in other Member States such requirements do not exist.

As pointed out by the mortgage lending industry during the Dialogue, mortgage lenders assess the creditworthiness of consumers on a regular basis and do not as a principle grant a loan if – based on a creditworthiness check – they reach the conclusion that the potential borrower will not be able to meet his repayment obligations.[61] However, although it is in a mortgage lender's interest to assess the creditworthiness of a consumer and thus the risks associated with providing a mortgage credit (for example, the borrower's probability of default in order to fulfil certain requirements set out by the Capital Requirements Directive[62]) this interest is not necessarily aligned with the interest of the potential borrower to choose the optimal product or in the interests of an investor who purchases a security based on a particular mortgage loan. Although any reasonable mortgage lender is unlikely to provide a loan to a consumer who is not able to meet his repayments, in the event of a borrower's default, the mortgage lender can always avail to the property which is held as collateral. Knowing this, the mortgage lender has less of an incentive to thoroughly analyse the creditworthiness of the borrower. As such, consumers might be encouraged to take out a mortgage loan at their current maximum financial ability in terms of repayments. In this case, consumers run a serious risk of loosing their home in the event of even small changes to their financial situation or small increase in interest rates if they have taken out a variable interest rate loan. This asymmetric relationship means that the interests of a mortgage lender and borrower are skewed. A mortgage lender that is aware that he will transfer the risks of the consumer failing to repay to third parties by, for example, issuing residential mortgage backed securities or selling the loan portfolio, may also have a diminished incentive to maintain his lending standards. Finally, the effort to ensure that the mortgage lender fully understands the specific circumstances of the consumer takes time and therefore represents a cost to the mortgage lender. In cases where the consumer is eager to obtain a mortgage loan quickly, the mortgage

58 Dutch Financial Services Act, 12.5.2005, Section 32.

59 *Mortgage and Home Finance: Conduct of Business Sourcebook*, UK Financial Services Authority, MCOB 4.7 Advised sales, http://fsahandbook.info/FSA/html/handbook/MCOB/4/7.

60 Cf. footnote 49, Chapter 1.

61 Cf. footnote 27, p. 7.

62 Annex V, point 3 of Directive 2006/48/EC, 14.6.2006.

lender may seek to provide an offer as soon as possible in order to prevent the customer from looking elsewhere.

Taking these factors into account, there is a risk that a mortgage lender decides not to invest as much time and effort in assessing the creditworthiness of a borrower as perhaps should be the case. As a consequence, the consumer might be presented with a range of products that does not fully reflect his financial needs and circumstances. Consequently, there is a risk that the consumer chooses a product for which there is a chance that consumers may fail to meet their contractual obligations and thus may eventually loose their home.

Although evidence of such practices is scarce, some limited data is available. In the UK, for example, a recent review of the behaviour of intermediaries and mortgage lenders providing services to consumers with impaired credit histories found that in a third of the files reviewed, there was an inadequate assessment of consumers' ability to afford the mortgage credit product sold; in almost half the files reviewed there was an inadequate assessment of customers' suitability (e.g. needs and circumstances) for the mortgage.[63] The question of a borrower's ability to repay has also received a lot of attention recently in the United States where responsible lending rules are being reviewed in the wake of the developments in sub-prime markets. For example, the fact that many borrowers are unable to afford the monthly payments after the initial rate adjustment because of payment shock has led to rising foreclosures in the US.[64]

Although these issues have a strong domestic dimension, the question of how the mortgage lender assesses a borrower's creditworthiness and thus presents a range of products which are suitable for the borrower is not without cross-border implications. The disparity of rules at the European level has consequences for consumers and investors. From a consumer perspective, it is primarily a question of confidence. Given the high value of a mortgage credit together with its social and economic importance, consumers need to be confident that they are taking out the best product for their needs. In an efficiently functioning single market, consumers need the confidence to be able to shop around regardless of the location of the provider (domestic or otherwise). From an investor perspective, there is a chance of moral hazard. With asymmetric information between the mortgage lender and investor, the investor is unaware of how the mortgage lender has reached its decision to grant a loan to a borrower and thus his judgement regarding the borrower's ability to repay the loan. Capital markets are international as the recent developments of US sub-prime markets and their impact on European financial institutions have illustrated. Investors therefore need to have confidence in the lending practices of mortgage lenders across Europe.

1.3.2.2. Sub-optimal advice

Another reason why a consumer might not get the product needed or sought might be that an adviser fails to provide the right recommendation. Any advice given must in principle be appropriate and balanced in order to be useful for the consumer. However, according to the information provided to the Commission, in a majority of Member States, there are no

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63 *FSA finds poor practice by intermediaries and lenders within sub-prime market*, UK Financial Services Authority, 4.7.2007, http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/081.shtml.

64 *Interagency Proposed Statement on Subprime Mortgage Lending*, US Federal Register, Vol. 72, No. 45, 8.3.2007.

standards regarding the provision of advice in the area of mortgage credit and therefore no monitoring on the quality of advice given.

Some advisers might fail to provide independent advice because of disincentives to do so, e.g. because they receive different levels of remuneration from different product providers for the sale of different products. This give advisers an incentive to sell certain products, not necessarily because it is in the interest of the consumer but because it is in the adviser's own financial interest. In addition, if an adviser fails to take fully into account the personal circumstances of the borrower, because the time to assess those circumstances represents a cost for the adviser, there is a risk that a unsuitable product is recommended, leading – in the worst case scenario – to the default of the consumer. This would have knock-on consequences for both the mortgage lender or, if the loans were sold or securitised, investors, who would face a greater risk of default of the loan and would have to manage the consequences.

In an integrated market, the provision of objective advice plays a particularly significant role. In such a market, mortgage lenders can enter markets and offer their own range of products and, at the same time, consumers can, if they wish, shop cross-border for a progressively wider variety of products. As a consequence, consumers will be faced with choosing from a wider range of unfamiliar and even more complex products. Being able to receive advice will therefore be increasingly vital in terms of consumer confidence. Given the high value of a mortgage credit together with its social and economic importance, consumers need to be confident that they are taking out the best product for their needs. From a mortgage lender or investor perspective, there is risk of problems arising from moral hazard in that the adviser may have incentives to recommend a product other than the one which is best suited for the consumer.

Table 8: Problems and consequences

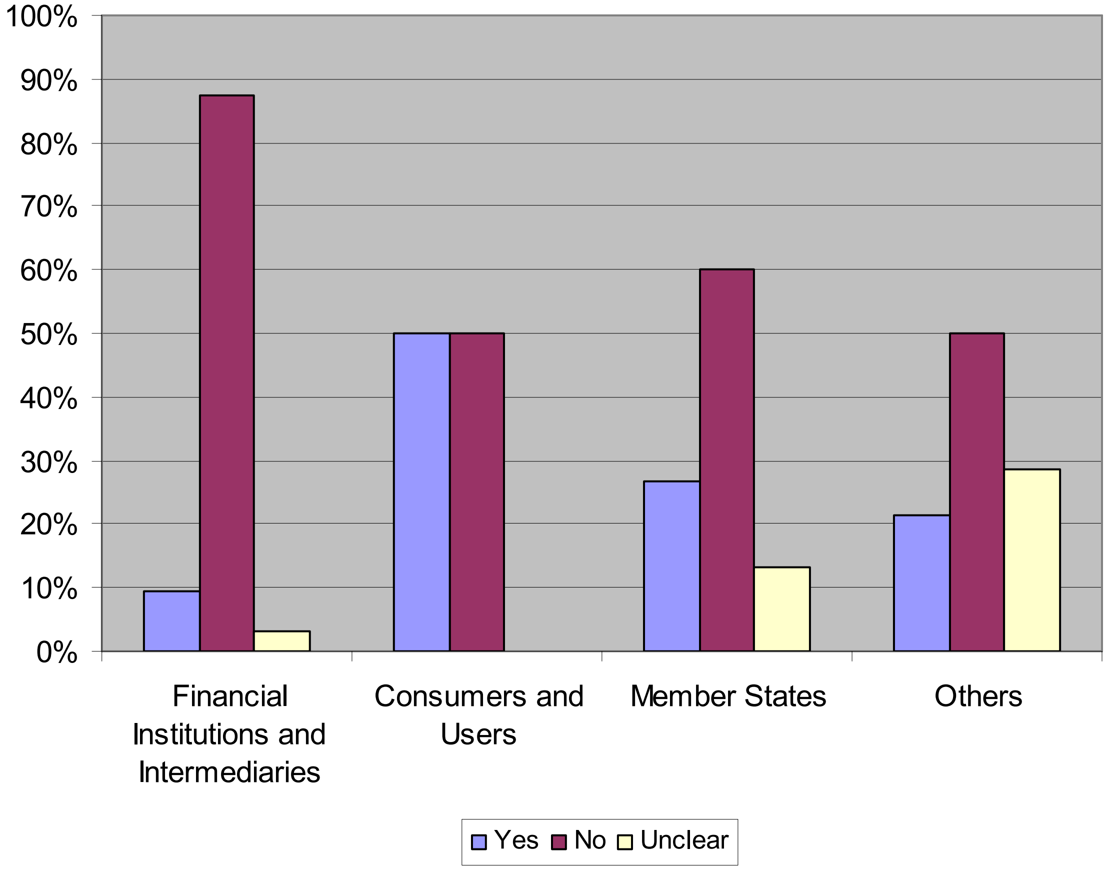
Problems	Consequences
▪ Insufficient or incorrect assessment of creditworthiness ▪ Sub-optimal advice	For consumers: – Consumers purchase a mortgage product which is not suitable => risk of inability to keep up with payments => risk of overindebtedness and foreclosure on home => reduced consumer confidence. For mortgage lenders: – Risky mortgage lending practices through bad assessment of creditworthiness or consumer being recommended an inappropriate product => potential losses through rise of lending inappropriate products and/or moral hazard For investors: – Purchase overrated securities => potentially high losses due to high defaults of borrowers.

1.3.3. Stakeholder's views

1.3.3.1. Consumers

Consumer organisations generally favour mandatory advice because, by receiving advice, consumers might compensate for the information/knowledge asymmetry between consumers and lenders.[65]

Graph 7: Should the provision of advice be compulsory?

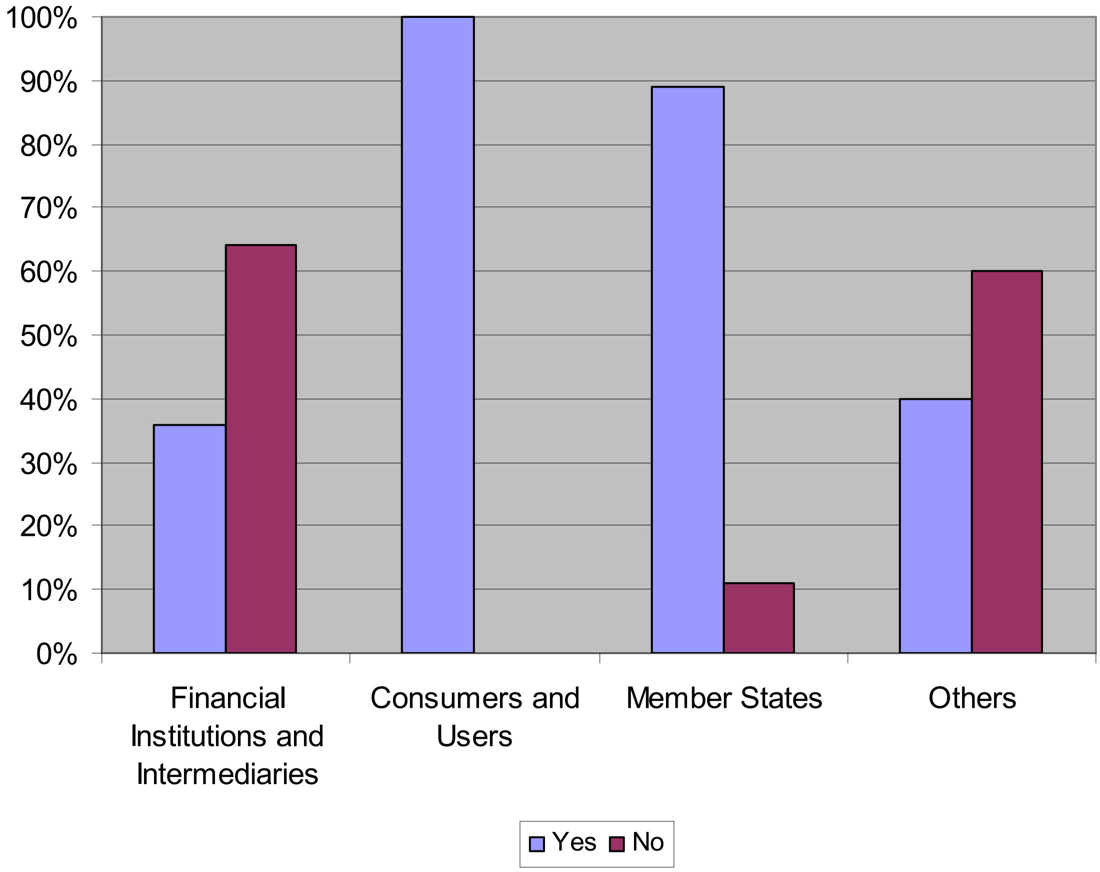


Source: *Feedback on the Consultation on the Green Paper on Mortgage Credit*, 23.5.2006, p. 15.

Consumer representatives also argue that by receiving advice, over-indebtedness can be avoided. Consumers highlight the need for 'best possible advice' to be provided and are therefore in favour of introducing standards for advice.[66]

65 Cf. footnotes 27, p. 6 and 35, p. 15.
66 Cf. footnotes 27, p. 7 and 35, p. 16.

Graph 8: Should conditions be applied to any advice provision?



Source: *Feedback on the Consultation on the Green Paper on Mortgage Credit*, 23.5.2006, p. 16.

1.3.3.2. Mortgage lenders

The majority of mortgage lenders oppose the introduction of mandatory advice but should remain a separate, 'tailor-made' service and that, if provided, it should be on request and against remuneration.[67] Mortgage lenders argue that not all consumers necessarily need or require advice. Furthermore, imposing an obligation to provide advice would increase the cost of all mortgage loans.

1.3.3.3. Member States

Member States are divided in their views as to whether the provision of advice should be compulsory with a majority opposed to the introduction of mandatory advice.[68] The majority of Member States are however in favour of introducing standards for the provision of advice.[69]

67 Cf. footnotes 27, p. 6 and 35, p. 15.
68 Cf. footnote 35, p. 15.
69 Cf. footnote 35, p. 16.

1.3.4. Objectives

In general, the Commission seeks to ensure that in a competitive marketplace, consumers are able to identify and take out the best products for their needs. More specifically, it should be ensured that:

- mortgage lenders, and intermediaries where appropriate, sufficiently assess the creditworthiness of a borrower;

- consumers have access to objective advice which is based on the profile of the customer and commensurate with the complexity of the products and the risks involved.

1.3.5. Description of options

1.3.5.1. Option 1: Do nothing

Doing nothing would mean that all the problems identified above remain. Consumers shopping around would face the risk of being sold an inappropriate product. Investors would face the risk of investing in riskier securities that envisaged. Mortgage lenders working with intermediaries would face the risk of lending inappropriate products to inappropriate consumers. Doing nothing can therefore be rejected at this stage.

1.3.5.2. Option 2: Recommendation

The Commission could publish a recommendation, encouraging Member States to develop requirements to ensure that mortgage lending is undertaken responsibly and/or to ensure that minimum principles are in place for providing advice. The recommendation could outline best practices in terms of practices undertaken by mortgage lenders/intermediaries on their own initiative and/or legislation by Member States.

1.3.5.3. Option 3: Self-regulation

Mortgage lenders, and intermediaries where appropriate, could with consumer associations agree on a Code of Conduct in which they commit themselves to thoroughly assessing a consumer's creditworthiness and/or providing advice according to certain standards.

The Mortgage Industry and Consumer Dialogue could be re-convened with a mandate to reach an agreement on creditworthiness and/or advice standards. If it is decided to maintain the existing Code of Conduct on Home Loans, the agreement on creditworthiness and/or advice standards could be incorporated. Alternatively, if it is decided to discontinue the aforementioned Code, an agreement on creditworthiness and/or advice standards, could – theoretically – also be a standalone agreement.

1.3.5.4. Option 4: Legislation

<u>Option 4.1: Oblige mortgage lenders to assess consumer creditworthiness</u>

The Commission could propose legislation which obliges mortgage lenders, and where necessary intermediaries, to lend responsibly by assessing thoroughly the consumer's creditworthiness. In addition, or as an alternative, the Commission could consider the introduction of a duty for mortgage lenders to assess the risk situation of consumers.

Option 4.2: Oblige mortgage lenders to provide advice

The Commission could consider an obligation to provide advice.

Option 4.3: Optional provision of advice according to certain principles

The Commission could also develop high level standards for the provision of advice and oblige Member States to ensure that if advice is provided it is done so according to those standards.

1.3.6. Impact assessment

1.3.6.1. Option 2: Recommendation

By encouraging Member States to develop requirements to ensure that mortgage lending is undertaken responsibly and/or to ensure that minimum principles are in place for providing advice, the Commission's objectives could potentially be ensured.

The publication of a recommendation could in principle ensure both that the creditworthiness of consumers is sufficiently assessed and that they have access to objective advice which is commensurate with the complexity of the products and the risks involved. However, the extent to which the objectives are achieved would be dependent on whether and to what extent Member States incorporate the recommendations into national law.

If Member States were to implement the recommendation, mortgage lenders and/or intermediaries would face one-off costs in terms of introducing new procedures and eventually providing staff with the appropriate training. In addition, ongoing costs could emerge in terms of the potential liability of mortgage lenders and/or intermediaries against recommending or providing an inappropriate product. To prevent against such risks, mortgage lenders and/or intermediaries may decide to document how a decision to recommend and/or offer a product was reached. These costs could potentially be passed on to consumers in terms of higher prices. In the event that not all Member States decide to implement the recommendation or do it to varying degrees, the level playing field between mortgage lenders in different Member States would be distorted. Depending on the extent of implementation, the costs for entering new markets would vary and act as a deterrent to new market entrants thus limiting competition.

For consumers, the end result would theoretically be consumers opting for the best product to meet their needs, or at least being able to choose a product which is, if not the best, certainly not one which is unsuited for their needs. Consumers should therefore be able to make a more informed choice of product. Although this should impact on the overall level of overindebtedness and reduce the number of foreclosures on properties, the policy could not entirely prevent them as such as there will always be cases where consumers fail to keep up with the payment obligations because of unexpected life events. There is also a risk that certain groups of consumers may be excluded from the market due to mortgage lenders and/or intermediaries adopting a more cautious approach to lending, therefore limiting product diversity. This could be particularly true for the so-called sub-prime group of consumers.

Table 9: Impacts of Option 2

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Recommendation	Consumers (D+I)	≈/+ purchase a suitable product for their needs (D) ≈/+ are able to access objective and appropriate advice (D) –/≈ price (I) –/≈ product availability (exclusion of certain groups of consumers) (I) + ↓ foreclosures (I)	Medium to long term	Dynamic	Medium (depending to what extent Member States implement the recommendations)
	Mortgage lenders (D)	– overall costs: => ↑ cost in terms of introducing new processes to assess a consumer's creditworthiness and staff training (D); => ↑ cost to cover potential liability (I) ≈/+ reduced risk of default	Medium to long term	Dynamic	Medium (depending to what extent Member States implement the recommendations)
	Intermediaries (D)	– overall costs => ↑ cost in terms of introducing new process to assess a consumer's creditworthiness and staff training (D) => ↑ costs to cover potential liability) (I)	Medium to long term	Dynamic	Medium (depending to what extent Member States implement the recommendations)
	Independent financial advisers (D)	– overall costs => ↑ cost in terms of introducing new processes and staff training (D) => ↑ costs to cover potential liability (I)	Medium to long term	Dynamic	Medium (depending to what extent Member States implement the recommendations)
	Member States (D)	–/– – ↑ Cost for introduction of legislation	Medium to long term	Dynamic	Medium (depending to what extent Member States implement the recommendations)

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
	Investors (I)	≈/+ reduced risk of default	Medium to long term	Dynamic	Medium (depending to what extent Member States implement the recommendations)

1.3.6.2. Option 3: Self-regulation

Self-regulation could in principle ensure that both the creditworthiness of consumers is sufficiently assessed and that they have access to objective advice which is commensurate with the complexity of the products and the risks involved.

If an agreement on a Code were reached, it would become immediately applicable to those organisations who have subscribed to it, quickly bringing the benefits of the modifications to consumers. This has the potential to improve consumer and investor confidence. However, as the previous Mortgage Dialogue in 2006 between consumer and mortgage lending industry representatives illustrated, reaching an agreement could potentially be a long and difficult task, thereby neutralising the benefits of self-regulation to a certain extent. For self-regulation to be successful, adherence to and implementation of the Code would have to be carefully monitored and enforced.

In terms of costs, those mortgage lenders and/or intermediaries who decided to adhere to the Code would face one-off costs in terms of introducing new procedures and eventually providing staff with the appropriate training. In addition, ongoing costs could emerge in terms of the potential liability of mortgage lenders and/or intermediaries for recommending or providing an inappropriate product. To prevent against such risks, mortgage lenders and/or intermediaries may decide to document how a decision to recommend and/or offer a product was reached. These costs could potentially be passed on to consumers in terms of higher prices. This would create a distorted playing field between mortgage lenders and/or intermediaries who decide to adhere to the Code and thus may raise their prices to cover their potential liability and those who decide against subscribing to the Code and could offer their products at a lower price. This fact alone could deter mortgage lenders and/or intermediaries from subscribing to the Code. In addition, some mortgage lenders and/or intermediaries subscribing to the Code might face additional costs from adhering to national legislation on advice standards and/or on requirements with regard to the assessment of the creditworthiness.

Consumers should theoretically opt for the best product to meet their needs, or at least be able to choose a product which is, if not the best, certainly not one which is unsuited for their needs. This should impact on the overall level of overindebtedness and reduce the number of foreclosures on properties, but is unlikely to entirely prevent them. As with the other options, there is also a risk that certain groups of consumers may be excluded from the market due to mortgage lenders and/or intermediaries adopting a more cautious approach to lending, therefore limiting product diversity. This could be particularly true for the so-called sub-prime group of consumers. Self-regulation would however have an important impact on consumers which should be taken into consideration. With subscription to the Code being voluntary, consumers would be faced with a choice between products which are offered by mortgage lenders and/or intermediaries adhering to the Code but are perhaps slightly more expensive and those offered by companies not adhering to the Code but which are perhaps slightly cheaper. Given the fact that many consumers value price as the most important factor[70], there is a risk that consumers prioritise 'price' over 'suitability'.

Table 10: Impacts of Option 3

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Self-regulation	Consumers (D+I)	≈/+ ↑ purchase a suitable product for their needs (D) ≈/+ ↑ to access objective and appropriate advice (D) –/≈ price (I) –/≈ product availability (exclusion of certain groups of consumers) (I) + ↓ foreclosures (I)	Medium to long term	Dynamic	Medium (depending to what extent adopted)
	Mortgage lenders (D+I)	– ↑ overall costs for those adhering to the Code => ↑ cost in terms of introducing new processes to assess a consumer's creditworthiness and staff training (D); => ↑ cost to cover potential liability (I) – potentially unequal level playing field (D) ≈/+ reduced risk of default (I)	Medium to long term	Dynamic	Medium (depending to what extent adopted)

[70] *Trends in Customer Loyalty and Acquisition Strategies in Europe 2007*, Datamonitor, 14.2.2007, Table 7.

Option	Affected parties Direct impact (D) Indirect impact (I)	Impacts ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	Timing One-off Short-term Medium-term Long-term	Nature Dynamic Static	Likelihood Certain High Medium Low
	Intermediaries (D+I)	– ↑ overall costs for those adhering to the Code => ↑ cost in terms of introducing new processes to assess a consumer's creditworthiness and staff training (D); => ↑ cost to cover potential liability (I) – potentially unequal level playing field (D)	Medium to long term	Dynamic	Medium (depending to what extent adopted)
	Independent financial advisers (D)	– overall costs => ↑ cost in terms of introducing new processes and staff training (D) => ↑ costs to cover potential liability (I)	Medium to long term	Dynamic	Medium (depending to what extent adopted)
	Member States (D)	≈	n.a.	n.a.	Certain
	Investors (I)	≈/+ reduced risk of default (I)	Medium to long term	Dynamic	Medium (depending to what extent adopted)

1.3.6.3. Option 4: Legislation

<u>Option 4.1: Oblige mortgage lenders to assess consumer credit worthiness</u>

A key advantage of legislation is that it would create a level playing field for mortgage lenders and/or intermediaries across Europe. Consumers would therefore not be forced to choose between 'price' and 'suitability'. This would have a positive effect on consumer confidence.

In terms of costs, as outlined above, mortgage lenders and/or intermediaries would face one-off costs to introduce new procedures and eventually provide staff appropriate staff training.

Consumers should end up opting for the best product to meet their needs, or at least being able to choose a product which is, if not the best, certainly not one which is unsuited for their needs. Although this should impact on the overall level of overindebtedness and reduce the number of foreclosures on properties, the policy could not entirely prevent them as such as there will always be cases where consumers fail to pay because of unexpected life events. There is also a risk that certain groups of consumers may be excluded from the market due to mortgage lenders and/or intermediaries adopting a more cautious approach to lending, therefore limiting product diversity. This could be particularly true for the so-called sub-prime group of consumers, in the absence of specific social programmes for them.

Option 4.2: Oblige mortgage lenders to provide advice

The Commission could consider an obligation to provide advice. The introduction of an obligation to provide advice would impact on consumers as well as mortgage lenders and intermediaries.

For consumers, an obligation to receive advice would ensure that a consumer receives a clear recommendation for one or more products. This recommendation would ensure that these products meet a consumer's individual needs. This could prove useful in particular for certain groups of consumers such as first time buyers or the self-employed. However, not all consumers (e.g. more experienced consumers) may need or even want advice for different reasons (e.g. because it is time consuming or because it may increase costs), but all will receive it and might have to pay for it.

In addition, mortgage lenders are only able to provide advice on the best product for a consumer's needs from within their own product range. Moreover, as the statistics in Section 1.3.1.2. illustrates, a large number of consumers do not actually trust advice when it is provided by their mortgage lender. Furthermore, advice potentially has a cost. If mortgage lenders were obliged to give advice, this would increase the overall cost of the mortgage lending process for consumers. For mortgage lenders, an obligation to provide advice could lead to an increase in the costs outlined in the previous paragraph. Moreover, a market for the provision of independent advice exists. There is a risk that companies, including many intermediaries, who specialise in providing advice, in particular independent advice, without necessarily actually offering the mortgage product, lose their business. By leaving this market open, competition between providers of financial advice would be promoted. Competition between providers would leave open the scope for providers of advice to offer their services at low prices, or potentially even for free, if mortgage lenders were trying to attract customers. It would however be for the market to determine the price. By leaving it to the market, it would be the decision of the mortgage lender to choose whether they want to engage in the market for financial advice or not and thus whether those costs were worthwhile. Consumers would also be free to choose whether they would like to receive advice and – possibly – incur the corresponding cost or whether they are confident in their own decision. More experienced or financially savvy consumers could then decide not to opt for advice.

Option 4.3: Provision of advice according to certain binding principles

The development and introduction of high level standards for the provision of advice would ensure that, if advice is given by any party, it meets a certain quality level. The definition of detailed standards should however be left to Member States who are in a better position to design standards tuned to the individual practices of mortgage lenders and needs of consumers in their jurisdictions.

In terms of costs, mortgage lenders and/or intermediaries would face one-off costs to introduce new procedures and provide staff appropriate staff training on how to provide advice according to the principles outlined. Ongoing costs may emerge in terms of the potential liability of mortgage lenders and/or intermediaries for recommending or providing an inappropriate product. To prevent against such risks, mortgage lenders and/or intermediaries may decide to document how a decision to recommend and/or offer a product was reached. These costs could potentially be passed on to consumers in terms of higher prices.

If advice is provided, consumers should end up opting for the best product to meet their needs, or at least being able to choose a product which is, if not the best, certainly not one which is unsuited for their needs. Although this should impact on the overall level of overindebtedness and reduce the number of foreclosures on properties, the policy could not entirely prevent them as such as there will always be cases where consumers fail to pay because of unexpected life events. There is also a risk that certain groups of consumers may be excluded from the market due to mortgage lenders and/or intermediaries adopting a more cautious approach to lending, therefore limiting product diversity. This could be particularly true for the so-called sub-prime group of consumers.

Table 11: Impacts of Option 4

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Legislation (creditworthiness)	Consumers (D+I)	+/++ ↑ purchase a suitable product for their needs (D) – ↓ product availability (exclusion of certain groups of consumers) (I) +/++ ↓ foreclosures (I)	Medium to long term	Dynamic	High
	Mortgage lenders (D+I)	– ↑ cost in terms of introducing new processes to assess a consumer's creditworthiness and staff training (D) + reduced risk of default (I)	Medium to long term	Dynamic	High
	Intermediaries (D)	– ↑ cost in terms of introducing new processes to assess a consumer's creditworthiness and staff training (D)	Medium to long term	Dynamic	High
	Member States (D)	– –/– ↑ costs for introduction of legislation (D)	Medium to long term	Dynamic	High
	Investors (I)	+ reduced risk of default (I)	Medium to long term	Dynamic	High
Legislation (obligatory advice)	Consumers (D+I)	+/++ purchase a suitable product for their needs (D) + are able to access advice (D) – –/– ↑ price (I) +/++ ↓ foreclosures (I)	Medium to long term	Dynamic	High

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
	Mortgage lenders (D+I)	– – / – ↑ cost in terms of introducing new processes, staff training and to cover potential liability (D) + reduced risk of default (I)	Medium to long term	Dynamic	High
	Intermediaries (D)	– –/– ↑ cost in terms of introducing new processes, staff training and to cover potential liability (D)	Medium to long term	Dynamic	High
	Independent financial advisers (D)	– – ↓ competition (risk of loss of business) (D) – – overall costs => ↑ cost in terms of introducing new processes and staff training (D) => ↑ costs to cover potential liability (I)	Medium to long term	Dynamic	High
	Member States (D)	– – / – ↑ costs for introduction of legislation (D)	Medium to long term	Dynamic	High
	Investors (I)	+ reduced risk of default (I)	Medium to long term	Dynamic	High
Legislation (optional advice according to certain principles)	Consumers (D+I)	+/++ purchase a suitable product for their needs (D) +/++ are able to access objective and appropriate advice (D) ? price if advice is not obligatory +/++ ↓ foreclosures (I)	Medium to long term	Dynamic	High
	Mortgage lenders (D+I)	– ↑ cost in terms of introducing new processes, staff training and to cover potential liability (D) + reduced risk of default (I)	Medium to long term	Dynamic	High
	Intermediaries (D)	– ↑ cost in terms of introducing new processes, staff training and to cover potential liability (D)	Medium to long term	Dynamic	High

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
	Independent financial advisers (D)	– overall costs => ↑ cost in terms of introducing new processes and staff training (D) => ↑ costs to cover potential liability (I)	Medium to long term	Dynamic	High
	Member States (D)	– –/– ↑ costs for introduction of legislation (D)	Medium to long term	Dynamic	High
	Investors (I)	+ reduced risk of default (I)	Medium to long term	Dynamic	High

1.3.7. Comparison of options

Improving the assessment of consumer's creditworthiness and the quality of advice available could significantly enhance consumer confidence by ensuring that high quality advice is available to help consumers assess the implications of a mortgage product and make a decision about which mortgage product is most appropriate for their individual needs. The provision of advice according to certain common standards could also facilitate cross-border activity by both mortgage lenders and consumers. Mortgage lenders would know that advice would be provided in accordance with certain principles across Europe. Common training programmes could be developed and synergies obtained. Consumers would likewise be able to shop around cross-border confident in the fact that the products they are being offered are based on a thorough assessment of their creditworthiness. Furthermore, if Option 4.2 or 4.3 were pursued, consumer confidence may be improved through the provision of quality advice, be it mandatory or optional. Investors would also face a lower likelihood of default.

Options 2–4 would all contribute to the fulfilment of these objectives to some extent, however, only Option 4 would be able to establish a level playing field across Europe and would thus have the most positive impact on consumer confidence. With Option 3 there is the risk that lenders face additional national legal requirements related to the assessment of consumer's creditworthiness and the advice. Mortgage lenders operating cross-border would therefore be subject to several product suitability requirements and the associated costs. The success of Options 2–3 would also depend on the willingness of Member States to change their legislation and the adherence of mortgage lenders to self-regulation respectively.

All options entail costs for mortgage lenders in terms of implementing new processes and ensuring the appropriate staff training. However, there is also the potential of costs for consumers in terms of higher prices for mortgage credit as well as reduced product diversity. These risks are slightly minimised under Option 3 as adhering to the Code would be on a voluntary basis for mortgage lenders. However, as described above, there is a risk that consumers then face a choice between 'price' and 'suitability'. The risk that consumer place price over suitability could in the medium to long term damage consumer confidence as in the event that they are unable to maintain their payments, they would lose their home. Taking into account, the risk of heterogeneous sets of suitability requirements, Option 3 can be discarded.

In conclusion, only Option 4 would meet the objectives set and create a level playing field throughout Europe. Option 4.1 obliging mortgage lenders to assess creditworthiness combined with either 4.2 or 4.3 would be most effective in terms of the specific objectives outlined above as well as in terms of improving consumer confidence. While Options 4.2–4.3 would both contribute to some extent to further ensuring that consumers select the most appropriate product, the benefits of Option 4.3 outweigh those of Option 4.2 by offering the opportunity for consumers to obtain advice on wider range of products (i.e. not just from the range of an individual mortgage lenders) as well as promoting a competitive market for advice. The quality of this advice would however be ensured through the existence of principles based standards. These benefits do not however come without a cost: for Member States and mortgage lenders/intermediaries in terms of implementing the legislation but also potentially for consumers in terms higher prices and a reduction in the availability of products.

Table 12: Overview of policy option effectiveness

Option		Specific objective	General objectives				Comments
		To ensure that mortgage lenders, and intermediaries where appropriate, sufficiently assess creditworthiness	Cross-border activity	Product diversity	Consumer confidence	Consumer mobility	
2	Recommendation	≈/+	≈	–/≈	≈/+	≈	Dependent on the extent to which implemented by Member States.
3	Self-regulation	≈/+	≈	?	≈/+	≈	Dependent on the extent to which subscribed to.
4.1	Legislation (creditworthiness)	+/++	≈	–/≈	+/++	≈	

Assessment: ++ = strongly positive; + = positive; – – = strongly negative; – = negative; ≈ = neutral/marginal; ? = uncertain

Table 13: Overview of policy option effectiveness

Option		Specific objective	General objectives				Comments
		To ensure consumers have access to objective advice which is based on the profile of the customer and commensurate with the complexity of the products and the risks involved, the complexity of the products and the risks involved	Cross-border activity	Product diversity	Consumer confidence	Consumer mobility	
2	Recommendation	≈/+	≈	–/≈	≈/+	≈	Dependent on the extent to which implemented by Member States.
3	Self-regulation	≈/+	≈	?	≈/+	≈	Dependent on the extent to which subscribed to.
4.2	Legislation (obligatory advice)	+/++	≈	≈	+/++	≈	Detrimental affect on the market for advice. Higher prices for consumers.
4.3	Legislation (optional advice according to principles)	+/++	≈	≈	+/++	≈	Potentially higher prices for consumers.

Assessment: ++ = strongly positive; + = positive; – – = strongly negative; – = negative; ≈ = neutral/marginal; ? = uncertain

2. EARLY REPAYMENT

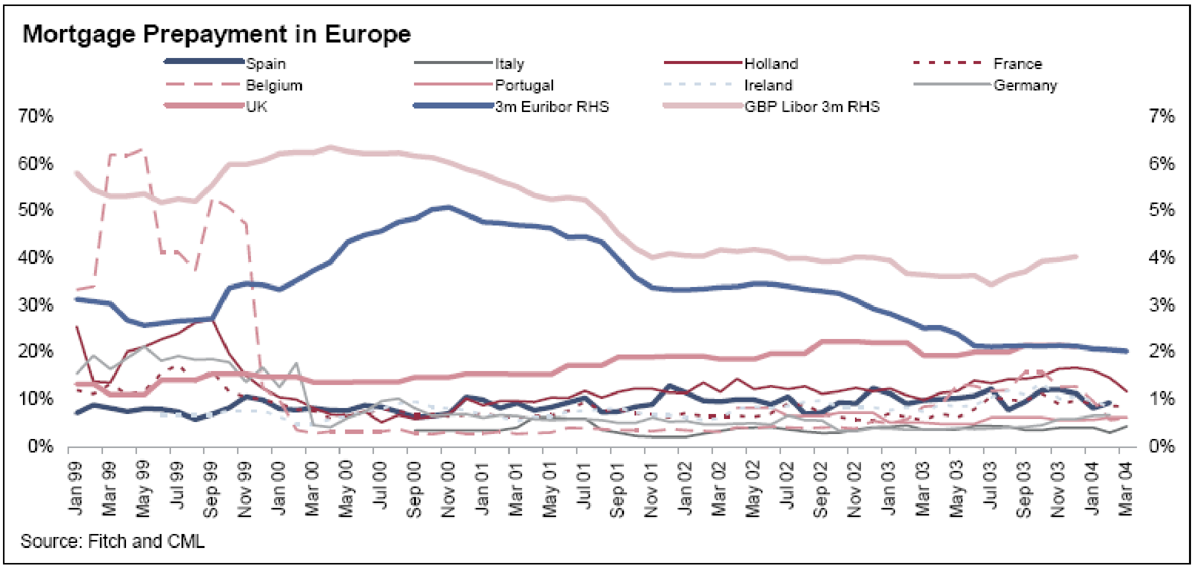
2.1. Context

Early repayment occurs when a loan is repaid by the borrower prior to a set period laid down in the terms and conditions of the loan.

The extent and reasons for early repayment vary considerably between Member States as well as between products. Factors influencing prepayment rate include the general interest rate environment, the use of fixed and variable interest rate loans, competition and innovation, the costs of refinancing (e.g. land registration, legal costs).[71]

[71] *Merrill Lynch Guide to International Mortgage Markets and Mortgage Backed Securities*, Batchvarov, Collins, De Pauw, Spencer, and Davies, 2003, p. 35.

Graph 9: Mortgage prepayment in Europe



Source: Fitch and Council of Mortgage Lenders

Early repayment regimes vary widely across Member States, from regimes where there is a universal legal right to early repayment exercisable at any time and under any circumstances[72], to regimes where the agreement on a right to early repayment is completely left to the contracting parties. In addition to those regimes, there are Member States that grant a legal right to early repayment only under certain conditions, e.g. after a certain time or under special circumstances.

Early repayment regimes also cover the compensation chargeable by mortgage lenders in the event of early repayment. In Latvia and since 2007 in Italy, legislation prohibits mortgage lenders from claiming any compensation. In Poland, no compensation can be claimed for loans below EUR 20 100, while for loans over this amount no legislation exists. However, apart from these three countries, according to the information provided to the Commission, in all other Member States (on which information has been received), legislation allows mortgage lenders to charge compensation for the early repayment of either or both fixed or variable interest rate loans. In countries where compensation can be claimed, the situation varies from countries where there are no legal limits to the amount of compensation that can be claimed to countries where the amount of compensation that can be claimed is legally restricted, for instance, France (6 months interest on repaid principal or 3% of outstanding principal, whichever is lower); Belgium (3 months interest); and Spain (1% of outstanding principal for variable rate loans). In addition, in a few cases, recommendations from national governments to the lending industry sometimes limit the amount of chargeable compensation. For instance, the Spanish government recommended that the compensation for early repayment of fixed rate loans should not exceed 2.5% of the outstanding value.

[72] Periods of notice may, however, differ.

Table 14: Early repayment in the EU

Country	Ability to repay		Compensation regime		
	Contractual option	Universal legal right	No compensation	Caps	No legal limits
Belgium		X		X	
Bulgaria	n.a.	n.a.	n.a.	n.a.	n.a.
Czech Republic	X				X
Denmark	X				X
Germany	X (1)	X (2)	X (3)		X (4)
Estonia	X (5)	X (2)			X
Greece	X				X
Spain		X		X	
France		X		X	
Ireland		X			X (6)
Italy		X	X		
Cyprus	X (7)	X (8)		X	
Latvia		X	X		
Lithuania		X (9)			X
Luxembourg	n.a.	n.a.	n.a.	n.a.	n.a.
Hungary	X				X
Malta	n.a.	n.a.	n.a.	n.a.	n.a.
Netherlands	X				X
Austria		X			X
Poland	X (10)	X (11)	X (11)		X (10)
Portugal		X			X
Romania	n.a.	n.a.	n.a.	n.a.	n.a.
Slovenia		X			X
Slovakia		X			X
Finland		X		X (12)	
Sweden		X			X (6)
United Kingdom	X				X

Sources: Information provided to the Commission, principally by Member States.[73], n.a. = information not provided to the Commission.
Notes: (1) For fixed interest rate loans. However, there is a right to terminate the loan at the end of the fixed interest period (if the fixed interest period ends before the allotted repayment date and no new agreement has been entered regarding the interest rate) and in any case after 10 years. These rights cannot be waived. In addition, there is a right to terminate the contract 'for cause' which requires a legitimate interest of the borrower, for instance if the borrower needs to sell his house due to a move. This right can be waived by the consumer. (2) For variable interest rate loans. (3) For variable interest rate loans at all times and for fixed interest rate loans after 10 years and at the end of a given fixed-interest period. (4) For fixed interest loans, in case of termination 'for cause'. (5) For fixed interest rate loans. (6) Only during the period of fixation for fixed interest rate loans. (7) For loans over EUR 85 000. (8) For loans under EUR 85 000 (rules for consumer credit apply). (9) Borrower shall have right to ERP to conditions established by contract. (10) For loans over EUR 20 100. (11) For loans under EUR 20 100 (rules for consumer credit apply). (12) Only if amount of credit exceeds EUR 17 000, interest rate is fixed and new interest rate by the same creditor is lower than the interest rate originally agreed upon. Maximum compensation is difference between interest rate originally agreed upon and new interest rate.

[73] See for all information in this section: comments provided by Government Expert Group on Mortgage Credit members, http://ec.europa.eu/internal_market/finservices-retail/home-loans/gegmc_comments_en.htm and comments received on the Green Paper on Mortgage Credit, http://ec.europa.eu/internal_market/finservices-retail/home-loans/comments_en.htm.

Early Repayment in Denmark

In Denmark, the right to early repayment is directly linked to the refinancing system. This is unique in Europe. The right to early repayment does not originate from law itself but has been developed by the market. Consumers can choose between two types of products.

(1) They can choose a loan which cannot be repaid early directly to the mortgage lender. This type of loan is refinanced by a non-callable bond. If the consumer wants to repay early, he can do so by buying bonds issued to fund the loan in an amount matching the outstanding debt of the loan in the market at market price and deliver it to the mortgage lender (delivery option). By delivering the bonds to the bank, the loan is repaid. Since the consumer is paying the market price for the bond, he might pay in praxis an indemnity to the investor (if the price of the bond is higher than par). In addition, the borrower pays a fixed fee to the mortgage lender (approximately EUR 127).

(2) They can choose a loan with an option to repay the mortgage lender early (call option). This loan is refinanced by a callable bond. The early repayment risk is reflected in the price of the callable bond. The interest rate payable on a callable bond is between 25 basis points to 75 basis points higher than the interest rate on a non-callable bond. This risk premium has to be borne by the consumer whose loan is accordingly more expensive. In addition, the borrower has to pay the same fixed fee to the mortgage lender as in case of the delivery option.

This system is both transparent and enables Danish consumers to prepay the loan at any time even if the option to prepay has not explicitly been selected at the outset. The costs for the consumer of repaying early are directly related to the actual costs for the mortgage lender of the early repayment of the loan, i.e. the consumer pays only refinancing costs and do not cover the costs of other borrower's repaying early.

2.2. Problem description

The existence of different national early repayment regimes and national levels of compensation for early repayment impose restrictions on cross-border lending, curb consumer demand, and limit product diversity thereby restricting consumer choice. The existence of certain early repayment regimes can also affect consumer mobility.

2.2.1. Different rules on when and under what circumstances consumers can repay early

The lack of common rules for early repayment acts as a barrier to cross-border lending, thus hampering product diversity, and impedes consumer confidence and mobility in countries where early repayment possibilities are more restricted.

The lack of common rules for early repayment forces mortgage lenders operating – or seeking to operate – cross-border to modify their products and pricing strategies to suit local legal requirements, e.g. by equipping their products with a right to early repayment. Any modification of products, however, reduces opportunities for economies of scale by creating additional costs for a mortgage lender, through higher refinancing costs, higher administrative costs, etc. and may mean that the costs of entering the new market outweigh the benefits. Without the prospect of profitability, a mortgage lender is less likely to enter the market.

Different legal requirements on early repayment also harm product diversity because they prevent mortgage lenders from offering certain types of products such as those with restricted or no early repayment facilities or long-term fixed rate products. For example, in countries where a legal right to early repayment is foreseen, products with restricted or no early repayment facilities cannot be offered because of the legal requirements. Products, where periods of 5, 7 or even 10 years of low interest rates are offered on the condition that there is no prepayment during a contractually specified time period, cannot therefore be easily offered.

One reason for the lack of cross-border activity by consumers is their lack of confidence about whether their rights will be upheld in another Member State.[74] For example, a consumer from a Member State with legal provisions that provide for a universal right to early repayment might be faced with a restricted legal right abroad. Different early repayment rules across Europe therefore dent consumer confidence by deterring them from engaging in cross-border activity.

Different rules on early repayment can also influence to what extent a consumer can switch mortgage lenders. For example, a legal right to early repayment exercisable at any time and under any circumstances gives consumers the ability to exit a long-term contract (see Table 14 above for examples). Without any right, a consumer is locked into the mortgage loan contract until the conditions for early exit – legally or contractually imposed – are fulfilled. Consequently, consumers may be unable to switch to a better offer and mobility is restricted, thus restricting competition between mortgage lenders.

2.2.2. Different rules on the compensation chargeable in the event of early repayment

Different rules for the compensation claimable in the event of early repayment act as a barrier to cross-border lending and product diversity and may impede both consumer confidence and customer mobility in countries where early repayment possibilities are more restricted.

A right to early repayment is a source of potential loss for the mortgage lender, because the mortgage lender faces costs from the repayment of the loan, e.g. – depending on the type of product – refinancing and administrative costs. A mortgage lender could, if the contract allows for it, cancel the funding contract to avoid on-going refinancing costs. In this case, the early repayment risk is passed to investors, which would demand a premium for taking on this risk. These costs would be asked and paid for at the conclusion of the funding contract and raise the cost of refinancing for the mortgage lender. However, not all funding instruments are callable before maturity.[75] In such cases, mortgage lenders may face considerable ongoing funding costs when the borrower repays early. In France, for example, some estimates put the

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74 *Internal Market – opinions and experiences of citizens in EU-25*, Eurobarometer 254, October 2006, p. 59.

75 With regard to covered bonds, only Danish covered bonds are callable in Europe. With the use of callable bonds, the risk of prepayment is passed to the investors. The margin on the interest rate compared to non-callable bonds reflects therefore the cost for the prepayment option for the consumer. Dübel estimated the price increase due to the prepayment option at about 10% in Denmark in 2005. See *Fixed rate Mortgages and Prepayment in Europe: A model review and conclusions for the prepayment indemnity model*, Hans-Joachim Dübel, October 2005, p. 26. In an update in 2007, Dübel estimates that the prepayment option is now slightly more expensive, reaching an average between 50 and 60 basis points compared to an average between 30 and 60 basis points in 2006. See *Empirical Dimensions of Prepayment Risk in Europe – A Brief Update per mid-2007*, Hans-Joachim Dübel, July 2007, p. 15. For further information see www.finpolconsult.de.

cost of early repayment to French banks between 1986 and 1996, where interest rates were steadily decreasing, at over EUR 6 billion[76], reaching over EUR 10 billion by the end of 2003[77]. The issue of prepayment costs is particularly pronounced for long-term fixed rate products as they are usually funded by mortgage lenders through long-term instruments to match the maturities of assets and liabilities in order to eliminate interest rate risk from the balance sheet.[78] Mortgage lenders may also face certain legal requirements in this regard.[79]

Refinancing costs, which are ongoing after an early repayment, may however be covered if the mortgage lender is able to reinvest the cash repayment at an equivalent interest rate. However, this is normally not the case because the prevailing interest rate level will usually be lower than the original interest rate as a decline in interest rates is –often an important incentive for consumers to repay early. If this is the case, and the compensation legally chargeable to the repaying consumer is insufficient to cover the actual costs from prepayment for the mortgage lender, early repayment will result in a loss for the mortgage lender.

If the legal regime of a country does not allow mortgage lenders to charge sufficient compensation to cover their costs in the event of prepayment of fixed or variable rate loans[80], a mortgage lender faces three options to avoid losses from early repayment.

First, mortgage lenders may refrain from offering certain products.[81] For example, they may choose not to offer long-term fixed rate products in favour of lending at short-time variable rates[82] in those countries to avoid the potential loss from prepayment. The disappearance of long-term fixed-rate loans that can be observed in the Spanish market, is attributed by some stakeholders, notably by the financial services industry, to the introduction of legislation foreseeing an unconditional right to early repayment combined with a maximum chargeable compensation of 1% of the repaid capital[83] in 1994.[84] As a result, mortgage lending in Spain

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76 Taken from a study by Professor Michel Mouillart (Université Paris X) published in the February 1999 issue of Banque Magazine.

77 In addition to lost income this figure includes additional management expenses associated with refinancing. See *French Banking Federation's observations on the European Commission Green Paper on Mortgage Credit*, http://ec.europa.eu/internal_market/finservices-retail/docs/home-loans/comments/repr-fr_fbf-en.pdf.

78 *Fixed rate Mortgages and Prepayment in Europe: A model review and conclusions for the prepayment indemnity model*, Hans-Joachim Dübel, www.finpolconsult.de , October 2005, p. 3. *There is no free lunch*, Deutsche Bank Research, July 2006, p. 9.

79 See, for instance, Article 4 of German Pfandbrief Act (Pfandbriefgesetz) of 22.5.2005 which requires matching the volume of covered bonds outstanding with loans of at least the same amount and with the same interest yield. In case of falling interest rates, where several consumers would repay early, the lender might not be able to replace all the loans serving as cover assets for covered bonds. As a result, gaps in the cover pool might occur.

80 For instance, in Finland, Germany, Ireland and Sweden.

81 London Economics cites the fact that French lenders are not permitted to charge borrowers for the full cost of prepayment as an example for legal restrictions that have as an immediate negative effect on the range of products available. See for example, *The Costs and Benefits of Integration of EU Mortgage Markets*, London Economics, August 2005, pp. 63–64.

82 Following the principle of matching the maturities of lending and funding, the funding for short-term variable rates would also be done at variable interest rates.

83 This applies to 'variable' loans only. In Spain, however, only those loans are considered fixed rate loans, where interest rates do not vary during the whole duration of the contract. A 20-year-loan which has an initially fixed interest rate period of 10 years would therefore be considered under Spanish law as variable loan.

84 *Study on the Financial Integration of European Mortgage Markets*, Mercer Oliver Wyman and the European Mortgage Federation, October 2003, p. 68; *Fixed rate Mortgages and Prepayment in Europe:*

is now done almost exclusively at short-term variable rates, where the initial period of fixation is less than a year.[85] As a consequence, households bear the risk of rising interest rates.[86] This leads to fluctuations in household disposable income or even over indebtedness[87] and has an impact on house prices[88], therefore impacting on level of financial stability. Mortgage lenders' concerns about covering the full range of their costs may lead therefore to the limited availability of long-term fixed rate products depending on the system in place thereby restricting consumer choice.

Second, mortgage lenders who are unable to adequately recover the costs of consumers repaying early through compensation may seek to recover the costs in other ways, for instance by charging the costs upfront in the form of a higher interest rate.[89] The higher interest rate is charged to all consumers who are entitled to repay early, regardless of whether they want to have the right or not. Studies estimate that the interest rate increase due to the incorporation of the cost of prepayment can range from nothing in countries such as the UK and Spain (where variable rate loans dominate the market and mortgage lenders are allowed to charge some compensation for variable rate loans at the time of early repayment) to as much as 4% (20 basis points in 2003 interest rate figures) in Italy and 6% (29 basis points on 2003 interest rate figures) in France compared to loans without prepayment option.[90] The same study concludes that as a result of the restrictions on the compensation chargeable from mortgage lenders in case of early repayment in France, French mortgage loans in 2005 are approximately 30 basis points more expensive than German mortgage loans.[91]

Third, mortgage lenders may offset the losses associated with early repayment by cross-subsidising mortgage loans with other products.[92] Alternatively, mortgage lenders may seek to cover those costs by tying other products such as current accounts or life insurance to the mortgage credit.[93] Consequently, inadequate compensation, which is too low to cover the mortgage lender's cost from early repayment, could also influence customer mobility.

Finally, mortgage lenders may also choose a combination of all of the above options.

A model review and conclusions for the prepayment indemnity model, Hans-Joachim Dübel, www.finpolconsult.de, October 2005, p. 27.

85 *Study on Interest Rate Variability in Europe*, European Mortgage Federation, July 2006, Table 2, p. 28: In 2005, 98% of mortgage debt outstanding in Spain was short-term with an initial period of fixation of less than a year.

86 The Bank of Spain has repeatedly warned credit institutions and households of the risks involved in pure floating rate mortgages. The IMF recommends for Spain to remove caps on credit institutions' commissions for early mortgage repayment. See *Spain: Financial Sector Assessment Program*, IMF Country Report No. 06/210, June 2006, pp. 13–14. For the United Kingdom, one study concludes more longer-term fixed rate lending would reduce the risks of over-indebtedness and of problems of debt affordability triggered by interest rate rises. *The UK Mortgage Market: Taking a Longer Term View*, David Miles, March 2004, p. 25.

87 In case of rising interest rates, some households would find it difficult to meet their payment obligations. This is illustrated by the current sub-prime crisis in the United States, where a lot of borrowers cannot afford their mortgage loans anymore due to rising interest rates.

88 The impact of a change in interest rates on house prices is likely to be substantially lower if there would be a higher share of long-term fixed rate borrowing, *The UK Mortgage Market: Taking a Longer Term View*, David Miles, March 2004, p. 24.

89 *There is no free lunch*, Deutsche Bank Research, July 2006, p. 11.

90 *Fixed rate Mortgages and Prepayment in Europe: A model review and conclusions for the prepayment indemnity model*, Hans-Joachim Dübel, Finpolconsult.de, October 2005, p. 26.

91 Cf. footnote 90, p. ii.

92 See Section 3. (Product tying) and Annex 1.

93 See Section 3. (Product tying) for further information.

In addition, to the ways described above, the level of compensation can also impact consumer behaviour. Consumers may incur a range of costs when repaying early or switching products and/or providers including charges levied by the mortgage lender, fees for the constitution and registration of the mortgage, taxes, notary fees, etc. The charges to be paid vary however, depending on the legal and contractual framework for early repayment, on the reasons for early repayment (i.e. to purchase a new property or refinance an existing property) as well as whether the consumer takes out a new mortgage with a new bank or remains with the same mortgage lender. In deciding whether to repay early or not, a consumer needs to weigh up the potential costs and benefits of repaying early. If the level of early repayment compensation charged by the mortgage lender, the level of fees for the constitution and registration of the mortgage[94], taxes or notary fees add up to a considerable amount, absorbing the interest rate margin to the better offer, then the consumer may face an economic barrier in repaying early. Studies estimate that the compensation to be paid to mortgage lenders can account for a considerable amount of the overall costs for early repayment. For instance, for a 10 year fixed mortgage loan over EUR 100 000 with 6% interest the compensation to be paid to the mortgage lender are estimated between 1.5% in Belgium to up to around 10% in Germany, depending on the interest rate development[95].

The different rules on the compensation chargeable in the event of early repayment also impede consumer confidence as to whether their rights will be upheld in another Member State. For example, a consumer from a Member State with legal provisions that provide for no compensation or only limited compensation in case of early repayment might be faced with no limits to compensation in other Member States. Different rules on the compensation chargeable in the event of early repayment across Europe therefore dent consumer confidence by deterring them from engaging in cross-border activity.

Table 15: Problems and consequences

Problem	Consequences
Different legislation on early repayment: ▪ When and under what circumstances consumers can repay early varies ▪ Compensation payable in the event of early repayment differs	For consumers: – Consumer choice restricted in certain markets – Customer mobility restricted – Lack of consumer confidence in engaging in cross-border activity – Uncertainty about the cost of early repayment in some markets (lack of price transparency) For mortgage lenders: – May not be able to offer products in all Member States => unexploited economies of scale => higher costs of cross-border activity (need to adapt products).

94 See Section 7. (Land registers) for further information.

95 *Vorfälligkeitsentschädigung in Europa*, Institute for Financial Services (IFF), January 2004, pp. 23–24. However, the results for this study are heavily criticised, see for instance footnote 90, pp. 9–10.

	– May not be able to claim adequate compensation => possible losses on certain products => need to adapt pricing strategies => bundling and tying. => reduced incentive for cross-border activity.

2.3. Stakeholder's views

The issue of early repayment is probably the most heavily debated issue among stakeholders.

2.3.1. Consumers

Consumers generally favour introducing a legal right to early repayment at the European level .[96] During the Mortgage Industry and Consumer Dialogue,[97] consumer representatives contested industry's view that introducing a legal right to early repayment would result in a reduction in product diversity, and highlighted that the ability of lenders to refinance and the enhanced market dynamism/competition would mitigate any potential costs. Consumer representatives also opposed allowing consumers to waive their right to early repayment generally (should they have such a right), since, in their view, consumers are unlikely to be in a position where they can negotiate with the contractual conditions with a mortgage lender. Consumer organisations rejected the argument of potential systemic risks in the event of mass early repayment. They stated the Danish mortgage system has handled substantial periods of refinancing of mortgage credits during periods of falling interest rates without any impact on financial stability. Consumer representatives also noted that, in any case, the current level of consumer protection at national level shall not be called into question.

The majority of consumer representatives agree that lenders should receive compensation when a consumer repays early.[98] However, some consumer representatives argued that compensation should only apply for fixed interest rate loans and not for variable interest rate loans.[99] Consumer representatives generally support capped compensation.[100]

2.3.2. Mortgage lenders

The majority of mortgage lending industry is in favour of early repayment being left to contractual freedom[101]. Mortgage lenders supporting the contractual option stated that the introduction of a right would not only potentially impact on prices and product diversity, but could also potentially create systemic risks in the event of mass early repayments in times of falling interest rates.[102] Should a right to early repayment be granted, allowing for a waiver was deemed essential by mortgage lenders.

With regard to compensation, most mortgage lenders advocated the harmonisation of early repayment fees.[103] The mortgage lending industry is opposed to any caps, arguing that only a full reimbursement of the lender for all losses could be considered to be 'fair and

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96 Cf. footnotes 27, p. 8; 35, p. 18 and 15, p. 4.
97 Cf. footnote 27, p. 8.
98 Cf. footnotes 27, p. 8; 35, p. 20 and 15, p. 4.
99 Cf. footnote 27, p. 8.
100 Cf. footnotes 27, p. 8 and 15, p. 4.
101 Cf. footnote 27, p. 8.
102 Cf. footnote 27, p. 8.
103 Cf. footnote 15, p. 4.

objective'.[104] Mortgage lenders argued that limited compensation would oblige lenders to mutualise their risks, i.e. to divide potential losses among all mortgage borrowers.

2.3.3. Member States

Member States are divided in their views as to whether early repayment should be a legal right or whether this issue should be left to the contracting parties.[105] On the question of compensation, Member States generally agree that there should be compensation for the lender in case of early repayment, however, are split as to the level of compensation.[106]

2.4. Objectives

Early repayment rules are pivotal for the integration of EU mortgage markets from both the demand and supply perspectives. On the demand side, well-balanced early repayment rules can improve consumer confidence and facilitate customer mobility. On the supply side, flexible – yet aligned – early repayment rules can facilitate the cross-border supply of mortgage credit by removing the barriers and reducing the costs of engaging in cross-border activity in order to promote competition and consumer choice. These objectives create a dilemma for policymakers who need to carefully balance the demand and supply side objectives.

The Commission should therefore ensure that consumers have an option to repay early at a fair and objective price and are not locked into their mortgage contract over the long term, particularly in unforeseen circumstances. At the same time, the Commission should ensure that mortgage lenders are not restricted in offering the full range of products, with or without early repayment facility, on their national markets and on a cross-border basis.

2.5. Description of options

2.5.1. Option 1: Do nothing

Mortgage lenders could still face difficulties in offering their products in another Member State without adapting them to local early repayment rules, restricting competition between mortgage lenders and consumer choice. Consumers would remain uncertain about cross-border activity due to the prevalence of different early repayment regimes. Customer mobility would remain limited in some instances. Much of the potential benefits of integration would not be achieved.

2.5.2. Option 2: Self-regulation

Self-regulation would bring little change to the current situation. Binding legislation in Member States would continue to exist and mortgage lenders would be obliged to comply with the legislation in place in different Member States. Mortgage lenders would still therefore be unable to offer their products in another Member State without adapting it to local early repayment rules, restricting competition between mortgage lenders and consumer choice. Consumer confidence in terms of cross-border activity would be low because of the

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[104] Cf. footnotes 27, p. 8; 35, p. 21 and *Report of the Mortgage Funding Expert Group*, 22.12.2006, p. 15, http://ec.europa.eu/internal_market/finservices-retail/home-loans/integration_en.htm#mfeg.

[105] Cf. footnote 35, p. 18.

[106] Cf. footnote 35, p. 20.

different early repayment regimes. Customer mobility would remain limited in some instances. In addition, as the experience with the Mortgage Industry and Consumer Dialogue illustrated, reaching self-regulatory agreement could be difficult. This option can therefore be discarded already at this stage. Consequently, self-regulation is not an option.

2.5.3. Option 3: Legislation

2.5.3.1. Option 3.1: Unconditional liberalisation of early repayment regimes (contractual option)

Early repayment regimes and compensation could be fully liberalised. This option would require Member States to abolish all rules on early repayment, including the rules which, in some countries, provide consumers an unconditional right to repay early, in order to lift any obstacle to the provision, within their territory, of loans with or without early repayment facility. This option could be implemented in a number of different ways depending on the existing legal requirements in different Member States. For example, it could be introduced either by introducing a full contractual option, by having a right to early repayment but allowing consumers to waive it, etc.. As a consequence, mortgage lenders would have the opportunity to offer, in every Member State, both loans with or without early repayment facilities. However, in order to ensure that the consumer is aware of the specificities and the implications of the various early repayment regimes available, clear, objective, accurate and comprehensive information would need to be provided by the mortgage lender.

Liberalisation of early repayment regimes could be combined with two options in terms of compensation:

- compensation could be liberalised by making it a contractual option agreed between mortgage lender and borrower but within certain limits, for example, by ensuring that it is 'fair and objective' and that it reflects only the actual costs borne by the mortgage lenders;

- caps could be introduced to limit the level of compensation to be paid by the consumer.

2.5.3.2. Option 3.2: Liberalisation of early repayment regimes (contractual option) but with a right to early repayment in certain circumstances

As with the previous option, early repayment regimes and compensation could be liberalised, giving a free choice, in every Member State, between loans with or without early repayment facilities. This would require Member States to lift any obstacle to the provision, within their territory, of loans with or without early repayment facility. As said before, in order to ensure that the consumer is aware of the specificities and the implications of the various early repayment regimes available, clear, objective, accurate and comprehensive information would need to be provided by the mortgage lender.

In contrast to the option of full liberalisation, some targeted safeguards could be foreseen. For example, in some specific circumstances, such as death or unemployment, consumers who have contracted a loan without an early repayment option could, if these circumstances materialise, have the possibility to repay early irrespective of what their contract stipulates. In addition to unforeseen circumstances, consumers might not be tied into their mortgage contracts without an option for early repayment for more than, for example, ten years.

As for Option 3.1, liberalisation of early repayment regimes with certain safeguards could be combined with several options in terms of compensation:

- compensation could be liberalised by making it a contractual option agreed between mortgage lender and borrower but within certain limits, for example, by ensuring that it is 'fair and objective' and that it reflects only the actual costs borne by the mortgage lenders;

- caps could be introduced to limit the level of compensation to be paid by the consumer.

2.5.3.3. Option 3.3: Introduce a compulsory right to early repayment

A right to early repayment could be introduced enabling consumers to repay at any time during their mortgage credit contract.

A right to early repayment could be combined with several options in terms of compensation:

- compensation could be liberalised by making it a contractual option agreed between mortgage lender and borrower but within certain limits, for example, by ensuring that it is 'fair and objective' and that it reflects only the actual costs borne by the mortgage lenders;

- caps could be introduced to limit the level of compensation to be paid by the consumer.

2.5.3.4. Option 3.4: Mutual recognition of early repayment regimes

Legislation could be adopted providing for the mutual recognition of early repayment regimes and compensation, leaving the existing national regimes untouched.

2.6. Impact assessment

The best viable option to address the problems arising from the different national early repayment regimes would be the introduction of legislation. Four different legislative options could be considered. At this stage, the net impact of these options cannot be easily assessed without a more rigorous quantitative impact analysis. Consequently, this section presents a general overview of the potential impacts of different legislative solutions in order to identify which option or options would potentially be the most effective.

2.6.1. Option 3.1: Unconditional liberalisation of early repayment regimes (contractual option)

A full liberalisation of early repayment regimes would promote competition and broaden consumer choice. At the same time, it would however, decrease in a number of countries the level of consumer protection offered by law, which could damage consumer confidence. By making early repayment regimes a contractual matter between the mortgage lender and consumer, mortgage lenders would be free to propose the full range of early repayment options and consumers would thus be free to agree upon one. Mortgage lenders seeking to gain a competitive edge would be free to offer consumers better deals of which early repayment terms and conditions could become an integral part.

Domestic mortgage lenders would be able to expand their product range and – potentially – branch out into new markets. Foreign mortgage lenders would be able to offer a wide range of products across Europe, without any need to modify the products according to local early repayment rules. Mortgage lenders could also specialise in providing one particular type of product, such as long-term fixed rate products with restricted prepayment possibilities. Such a business model could now be exported across Europe, where consumer demand exists. Whether by offering a full range of products or specialising in particular products, mortgage lenders would be able to obtain economies of scale and scope potentially offering cost savings. In general, competition would receive a boost and prices could potentially fall. Funding mechanisms could be specifically designed for certain products in order to achieve positive impacts on prices. For instance, with the possibility to limit prepayment options, mortgage lenders could use potentially cheaper funding mechanisms for which it is essential that the maturity of assets and liabilities are matched, such as covered bonds. This would have a positive impact on financial stability because mortgage lenders would be able to close their interest risk positions. Another example is the existing Danish model, which can be considered as a subset of this option. Any right to early repayment for consumers does not originate from law itself but has been developed by the market and is closely linked with specially designed funding mechanisms such as callable bonds and non-callable bonds (see box above).

Consumer choice would be widened. When coupled with appropriate comprehensive information, consumers would be empowered to make their own choice of which product is best for their needs. Consumers may shop around domestically and cross-border in the awareness that the early repayment rules that they face depend not on the legislative framework in place but on their own agreement. Consumers who feel that the mortgage lender does not propose an appropriate offer would be free to go elsewhere, provided that there are other solutions available and no other barriers to mobility in place[107]. However, this option would not be without risks for consumers, who may face a lower level of protection than they are used to for both domestic and cross-border transactions. This may have negative consequences for the overall level of consumer confidence or lead to consumer detriment.[108] Moreover, according to consumer representatives, many consumers may also become increasingly overwhelmed by the choice of products available. Giving consumers a choice of products means that there is a risk that some consumers make the wrong choice. For example, some consumers might choose a product without an early repayment option because the price of this product is cheaper than the price of a product with early repayment facilities without considering the implications in the long run, such as being locked into their contract for a long time without the possibility to shop around for a better deal. Market research suggests that past a certain point, when provided with more choice and information, consumers either walk away from markets, deciding not to choose, or when choosing, doing so randomly.[109] For consumers who make the wrong decision, consumer confidence could fall and customer mobility could be limited, thus limiting the scope for competition. Consumers opting for no early repayment option may also face indirect side effects. Without any early repayment option, consumers may be reluctant to switch jobs, leading to reduced labour mobility. Social issues may also arise should the consumer lose his job or face divorce proceeding.

Against this background, consumers face a trade-off between the advantages in terms of product diversity and the disadvantages in terms of confidence and mobility.

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107 See for example Section 1.1. (pre-contractual information), Section 3. (Product tying), and Section 7. (land registers).

108 The impact of these consequences can however be mitigated – at least to some extent – by initiatives, for example, to improve information and product suitability.

109 *Roundtable on Economics for Consumer Policy: Summary Report*, OECD, 20.4.2007, p. 11.

The liberalisation of early repayment regimes would represent a significant change with potential political impact for those Member States which currently provide for a compulsory legal right to early repayment and would accordingly impose costs for those Member States for the adaptation of their jurisdictions (See Table 14).

A liberalisation of early repayment regimes combined with a similar liberalisation of early repayment compensation would alter the abovementioned impacts the least. Mortgage lenders would be free to decide on the appropriate level of compensation in line with some basic principles, such as that the compensation should be fair and objective. Fair and objective compensation should cover any actual loss realised by the mortgage lender due to early repayment. Consumers could agree on the level of fees and reject any offer where they consider the level of fees excessive. In theory, mortgage lenders would be free to offer fees set as a fixed amount, such as a certain percentage on the outstanding loan amount at the time of prepayment, and would thus offer the consumer a degree of certainty about the cost of early repayment. Mortgage lenders could even waive the fees entirely under certain circumstances, such as when the consumer refinances with the same mortgage lender. How far mortgage lenders would be willing to go to attract consumers with low early repayment fees would however be dependent on the level of competition in the market and the value placed on early repayment facilities by consumers. However, it would be in the interest of mortgage lenders to charge those costs which reflect the actual costs attached to early repayment.

A liberalisation of early repayment regimes combined with a cap on the level of early repayment compensation could – depending on the level of the cap – have a more significant impact. The level of the cap is crucial in this regard. Should the level of the cap be set too high then the cap is irrelevant and there is a risk that the cap becomes the de facto norm for the level of compensation charged by mortgage lenders, thereby impacting on the incentives for consumers to repay early. Should the level of the cap however be set too low, then there is a risk that the compensation chargeable by mortgage lenders is insufficient to cover the costs incurred from early repayment, leading to higher prices for mortgage credits for all borrowers to offset the losses expected from early repayment or to the disappearance of certain products from the market, such as the disappearance of long-term fixed rate mortgages. The absence of long-term fixed rate mortgages in a market may have wider implications on households' indebtedness levels and the level of house prices.[110] Caps which are set too low also have an impact on overall financial stability. As described before, in France, where massive prepayments occurred after interest rates slumped, banks experienced substantial losses. Too low caps would also endanger certain refinancing systems, such as non-callable bonds. For instance, the massive prepayments in France lead to the collapse of the French Marché Hypothécaire – a non-callable bond system – in 1984.[111] Should certain capital market mortgage funding products, such as non-callable covered bonds, disappear from the market, mortgage lenders would have to turn to alternative, potentially more expensive refinancing tools and investors loose a specific investment opportunity.

Any EU regime on early repayment – combined with either liberalisation or the introduction of caps – would also represent a significant change and cost for those Member States which currently have a different compensation regime in place.

110 *The UK Mortgage Market: Taking a Longer Term View*, David Miles, March 2004, p. 25.
111 Cf. footnote 90, p. 27.

Table 16: Impacts of Option 3.1

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Unconditional liberalisation of early repayment regimes (contractual option) with liberalisation of early repayment compensation regimes	Consumers (D)	+/++ increased choice of products (D) <u>For Member States which currently have a right to early repayment:</u> –/≈ ↓customer mobility (some consumers will not have a right but those who want it can theoretically have it; depends on the cost of early repayment negotiated between the borrower and mortgage lender; not all customers will want to repay early) (D) – ↓ consumer confidence (D) – ↑ risk of consumer detriment (D)	Medium to long term	Dynamic	High
	Mortgage lenders (D)	+/++ ↑market access (D) +/++ ↑ economies of scale and scope (D) ≈ stability of financial institutions (D)	Medium to long term	Dynamic	High
	Investors (I)	+	n.a.	n.a.	High
	Member States (D)	– ↑ varying levels of cost for amending legislation for Member States (D)	One-off	Static	High

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Unconditional liberalisation of early repayment regimes (contractual option) with **caps** on early repayment compensation (assuming that caps are set below the level of actual costs incurred by mortgage lenders)	Consumers (D)	–/≈ choice of products (D) (depends on the size of 2 effects: the benefits of the liberalisation would most likely be offset to some extent by the restricting effects of the caps) –/≈ ↑ prices (D) (depends on the size of 2 effects: the benefits of the liberalisation would most likely be offset to some extent by the restricting effects of the caps) <u>For Member States which currently have a right to early repayment at any time:</u> –/≈ ↓ customer mobility (some consumers will not have a right but those who want it can theoretically have it; not all customers will want to repay early) (D) –/≈ ↓ consumer confidence (D) –/≈ ↑ risk of consumer detriment (D)	Medium to long term	Dynamic	High
	Mortgage lenders (D)	+/++ ↑ market access (D) –/≈ losses from early repayment (D) (depends on the size of 2 effects: the benefits of the liberalisation would most likely be offset to some extent by the restricting effects of the caps)	Medium to long term	Dynamic	High
	Investors (I)	≈ ↓ investment opportunities (I)	Medium to long term	Dynamic	High
	Member States (D)	– ↑ Cost for change of legislation for Member States with a right to early repayment and/or without caps on compensation (D)	One-off	Static	High

2.6.2. *Option 3.2: Liberalisation of early repayment regimes (contractual option) but with a right to early repayment in certain circumstances*

The impact of this option would be similar to those presented above (see Section 2.5.1.). The key difference would be to ensure that some of the risks faced by consumers by introducing a contractual early repayment option would be minimised by ensuring that consumers are able to repay early in certain circumstances. This approach would seek to ensure that market forces are balanced with appropriate levels of consumer protection in terms of customer mobility and consumer confidence.

The consumer could be granted a right to early repayment under certain circumstances. The average consumer is typically focused more on the short to medium term rather than potential unforeseen events. As such, there is a risk that consumers focus more on the potential price advantages of waiving an option to repay. By ensuring that consumers have the possibility to repay early in certain circumstances, indirect negative side effects such as reduced labour mobility as well as possible social issues arising through other unforeseen circumstances such as death, divorce or unemployment could potentially be avoided.

In addition to a right to early repayment under certain circumstances, a right to early repayment may also be considered after a certain period of time in order to ensure that consumers are not indefinitely locked into their mortgage contracts. For example, a right to early repayment might be foreseen after a number of years (i.e. ten). The presence of such a right would provide consumers with a degree of certainty, promoting consumer confidence. Such a measure would also take into consideration the benefits of mobility for competition and the market as a whole.

This approach would have in general similar impacts on mortgage lenders to those described above, e.g. domestic mortgage lenders would be able to expand their product range and foreign mortgage lenders would be able to offer a wide range of products across Europe, without any need to modify the products according to local early repayment rules. The possibility for consumers to repay early under certain circumstances or after a certain period of time would not change this effect. It would only have a limited negative impact on mortgage lenders for two reasons. First, the circumstances under which a borrower would be able to repay early would not be the rule but rather the exception. For instance, there would be no waves of prepayment as would be the case when consumers are granted a right to repay early at any time and there is a sudden drop in interest rates. Second, when consumers have a right to early repayment after a certain period of time, mortgage lenders can manage their funding according to the given time frame.

The introduction of a combined regime would require changes and create costs for all European Member States to varying degrees. Member States which currently provide for a right to early repayment at any time would need to substantially amend their legislation. However, Member States, which currently leave it to the contracting parties to negotiate whether the consumer has the option to repay early or not, would also face changes because they would have to ensure that the consumer has the possibility to repay early under certain circumstances and after a certain period of time.

The same impacts as described above can be expected from the different compensation systems.

Table 17: Impacts of Option 3.2

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Liberalisation of early repayment regimes (contractual option) but with a right to early repayment in certain circumstances with liberalisation of early repayment compensation regimes	Consumers (D)	+ ↑ choice of products (D) <u>For Member States which currently have a right to early repayment:</u> => –/≈ ↓ customer mobility (some consumers will not have a right but those who want it can theoretically have it; right in certain circumstances guaranteed but size of effect depends on the cost of early repayment negotiated between the borrower and mortgage lender; also not all customers will want to repay early) (D) => – ↓ consumer confidence (D) <u>For Member States which currently do not have a right to early repayment:</u> => ≈/+ ↑ customer mobility (right in certain circumstances guaranteed but size of effect depends on the cost of early repayment negotiated between the borrower and mortgage lender; also not all customers will want to repay early) (D) => –/≈ consumer confidence (D) –/≈ ↑ risk of consumer detriment (D)	Medium to long term	Dynamic	High
	Mortgage lenders (D)	+/++ ↑market access (D) +/++ ↑ economies of scale and scope (D) ≈ stability of financial institutions (D)	Medium to long term	Dynamic	High
	Investors (I)	≈	n.a.	n.a.	High
	Member States (D)	– ↑ varying levels of cost for amending legislation for Member States (D)	One-off	Static	High

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Liberalisation of early repayment regimes (contractual option) but with a right to early repayment in certain circumstances with **caps** on early repayment compensation (assuming that caps are set below the level of actual costs incurred by mortgage lenders)	Consumers (D)	–/≈ choice of products (D) (depends on the size of 2 effects: the benefits of the liberalisation would most likely be offset to some extent by the restricting effects of the caps) –/≈ ↑ prices (D) (depends on the size of 2 effects: the benefits of the liberalisation would most likely be offset to some extent by the restricting effects of the caps) <u>For Member States which currently have a right to early repayment at any time:</u> => –/≈ customer mobility (some consumers will not have a right but those who want it can theoretically have it; right in certain circumstances guaranteed; not all customers will want to repay early) (D) => – ↓ consumer confidence (D) => –/≈ ↑ risk of consumer detriment (D) <u>For Member States which currently do not have a right to early repayment:</u> => ≈/+ ↑ customer mobility (right in certain circumstances guaranteed , not all customers will want to repay early) (D) => ≈/+ ↑ consumer confidence (D)	Medium to long term	Dynamic	High
	Mortgage lenders (D)	+/++ ↑market access (D) – –/– losses from early repayment (D) – ↓stability of financial institutions (D)	Medium to long term	Dynamic	High
	Investors (I)	? ↓ investment opportunities (I)	Medium to long term	Dynamic	High
	Member States (D)	– ↑ cost for amending legislation for Member States (some will require more amendments than others) (D)	One-off	Static	High

2.6.3. Option 3.3: Introduce a compulsory right to early repayment

Introducing a compulsory right to early repayment would impact both on mortgage lenders and consumers.

For consumers, the introduction of a right to early repayment would enable them to repay their mortgage early whenever they wish. Consumers would never be locked in a mortgage contract thus enabling them to switch mortgage providers if a better offer were to become available, stimulating competition and developing the market. Consumers would be secure in the knowledge that this right would be the same everywhere in Europe and confidence would rise, potentially leading to a small to moderate rise in the number of consumers willing to shop around cross-border. Mortgage lenders would also no longer be forced to adapt their products to different national legal regimes, facilitating cross-border activity and offering economies of scale and scope.

At the same time, a right to early repayment at any time would restrict product diversity and could lead to higher prices in Member States, such as Denmark and Germany, where non-callable covered bonds are currently used to refinance mortgage loans and mortgage lenders do not take on the risk of early repayment[112].

Products, where periods of 5, 7 or even 10 years of low interest rates are offered on the condition that there is no prepayment during a contractually specified time period – however small, could therefore no longer be offered. Product diversity may be further restricted depending on the compensation regime adopted.

The introduction of a right to early repayment combined with a liberalisation of early repayment compensation to enable contractual agreements on compensation levels could mitigate somewhat the impact on product diversity. Mortgage lenders would be able to charge compensation to offset the actual costs associated with early repayment. However, it is unlikely that enabling mortgage lenders to charge appropriate levels of compensation would fully offset the impacts on product diversity. With a right to early repayment at any time there could be waves of prepayment in times when the level of interest rates sharply drops. Mortgage lenders refinancing their mortgage loans with non-callable covered bonds might be unable to replace all the mortgage loans serving as cover assets for covered bonds. The amount of the repaid loan including early repayment fees can in certain jurisdictions, such as Germany, only be used to a certain extent as a replacement for cover assets for covered bonds. For instance, under German covered bond law, money claims are only allowed to form up to 10% of the cover assets of covered bonds.[113] As a result, mortgage lenders would not be able to use non-callable covered bonds, such as the Pfandbrief in Germany, in its current form to refinance long-term fixed rate mortgages anymore. This could lead to higher prices for consumers if mortgage lenders use different, potentially more expensive refinancing tools or to the reduced availability of long-term fixed rate mortgages. Any changes to covered bond laws, providing for instance for the possibility that a higher share of cover assets can be hold

112 Spanish covered bonds are also non-callable. At the same time, consumers have a right to early repayment in Spain. Spanish mortgage lenders, which therefore bear the risk of prepayment, hedge themselves against this risk on the market. To buy this protection, Spanish mortgage lenders face certain costs, which they can either transfer to the consumer in form of higher interest rates or take on themselves.

113 Article 19 of German Pfandbrief Act (Pfandbriefgesetz) of 22.5.2005.

in money claims or that the covered bonds is callable against the investor, would change considerably the nature of existing covered bond laws in terms of safety for investors.

The introduction of a cap on early repayment compensation would exacerbate the impact on product diversity and prices. Mortgage lenders may simply decide to refrain from offering certain product types such as long-term fixed rate products if the costs of offering those products outweigh the possible benefits, thereby leaving the mortgage lender with no profit or possibly even with a loss. If a cap is too low to cover the cost from early repayment, mortgage lenders might also choose to charge all borrowers a higher interest rate from the beginning of the contract. Borrowers which do not intend to repay early would therefore be penalised because they would be cross-subsidising those consumers which make use of the early repayment option.

A capped compensation, which is too low to cover the mortgage lender's cost from early repayment, could however also influence consumer mobility. Mortgage lenders could use tying of products as a mean to offset the losses from a mortgage credit product with gains from other financial products. Consumers would therefore face greater switching costs when they want to prepay their mortgage loan and switch to another mortgage lender.

The introduction of right to early repayment would require changes and create costs for those European Member States which currently leave it to the contracting parties to negotiate whether the consumer has the option to repay early or not. Some of the Member States such as Germany, which have currently non-callable covered bond legislation in place, would also have to change their covered bond legislation. If the introduction of a right to early repayment is combined with caps on early repayment compensation, almost all Member States would have to change their legislation, even those which currently have a right to early repayment and caps on compensation because of the varying level of national caps.

Table 18: Impacts of Option 3.3

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Compulsory right to early repayment with liberalisation of early repayment compensation regimes	Consumers (D)	– ↓ choice of products (D) –↑ prices (D) <u>For Member States which currently do not have a right to early repayment:</u> ≈/+ ↑ mobility (but not all customers will want to repay early) (D) ≈/+ ↑ confidence (D)	Medium to long term	Dynamic	High
	Mortgage lenders (D)	+/++ easier market access (D)	Medium to long term	Dynamic	High
	Investors (I)	– ↓ investment opportunities (I)	n.a.	n.a.	High

Option	Affected parties Direct impact (D) Indirect impact (I)	Impacts ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	Timing One-off Short-term Medium-term Long-term	Nature Dynamic Static	Likelihood Certain High Medium Low
	Member States (D)	– ↑ cost for amending legislation for Member States (some will require more amendments than others) (D)	One-off	Static	High
Compulsory right to early repayment with caps on early repayment compensation (assuming that caps are set below the level of actual costs incurred by mortgage lenders)	Consumers (D)	–/– – ↓ choice of products (D) –/– – ↑ prices (D) For Member States which currently do not have a right to early repayment: + ↑ mobility (but not all customers will want to repay early) (D) + ↑ confidence (D)	Medium to long term	Dynamic	High
	Mortgage lenders (D)	+/++ easier market access (would create a level playing field) (D) – –/– losses from early repayment => cover losses with income from other sources (D) – ↓ stability of financial institutions (D)	Medium to long term	Dynamic	High
	Investors (I)	– ↓ investment opportunities (I)	Medium to long term	Dynamic	High
	Member States (D)	– ↑ cost for amending legislation for Member States (some will require more amendments than others) (D)	One-off	Static	High

2.6.4. *Option 3.4: Mutual recognition of early repayment regimes*

The impact of mutually recognising early repayment regimes across Europe would be significant. On the one hand, mortgage lenders would be able to go cross border in order to offer their products, without any need to modify the products according to local early repayment rules. Cross-border offers could therefore increase, hence improving product diversity on national markets. On the other hand, domestic mortgage lenders facing certain restrictions with regard to early repayment under their national law, such as being obliged to offer products with a right to early repayment, would have a disadvantage compared to foreign mortgage lenders because they could not accommodate those consumers which do not want to use their option to early repayment in exchange for a cheaper interest rate. Consequently, there would be an unequal level playing field for mortgage lenders.

Mutual recognition of early repayment regimes would also impact on consumers in several ways. Consumers would be offered a wider range of products through the increased cross-border activity by mortgage lenders and could choose from a range of products with different early repayment options. Consumers would therefore be able to choose the product with the best early repayment conditions for their individual needs. Such a situation could however lead to confusion on the part of consumers who would receive mixed messages. For example, on the one hand, in some Member States, consumers would have a right to early repayment but on the other hand, not all products would offer such a right. This would be confusing and thus detrimental to consumer confidence.

Member States would not face any direct costs from this option.

Table 19: Impacts of Option 3.4

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Mutual recognition of Early Repayment Regimes	Consumers (D)	+/++ ↑ choice of products (D) For Member States which currently have a right to early repayment and caps on compensation: –/– – ↓ confidence (D) – ↓ mobility (D)	Medium to long term	Dynamic	High
	Mortgage lenders (D)	+/++ easier market access (D) – unequal level playing field between mortgage lenders from Member States with and without right to early repayment and caps on compensation (D)	Medium to long term	Dynamic	High
	Investors (I)	≈	n.a.	n.a.	High
	Member States (D)	≈	n.a.	n.a.	High

2.7. Comparison of options

Option 3.1 would not be able to fulfil the specific objective of the Commission to ensure that consumers have an option to repay early at a fair and objective price and are not locked into their mortgage contract over the long term, particularly in unforeseen circumstances because this option could not guarantee that consumers would be able to repay in unforeseen circumstances and do not face the risk of being locked in over the long-term. This also holds true for Option 3.4.

Both Options 3.2 and 3.3 would ensure that the Commission fulfils its specific objective with regard to consumers assuming that fair and objective compensation could be charged. The positive impact on consumers with regard to the specific objective would be greater under Option 3.3 where consumers are granted the right to repay early at any time. Under Option 3.2, consumers do not have such a right to early repayment, however, they could opt for a product with a right for early repayment from the offer available on the market. If a consumer opts for a product without an early repayment facility, they would be protected over the long-term and in the event of unforeseen circumstances. With regard to the Commission's second specific objective to ensure that mortgage lenders are not restricted in offering the full range of products on their national markets and on a cross-border basis, Option 3.2 would have a greater positive impact than Option 3.3. Option 3.3 would not enable mortgage lenders to offer products without an early repayment facility. Consequently, mortgage lenders would be unable to offer the full range of mortgage products either at the national or at the European level. Option 3.2 would therefore help to increase product diversity when compared to Option 3.3. At the same time however, Option 3.3 would help improve consumer confidence. If caps (meaning compensation below the level of actual costs incurred by mortgage lenders) were to be chosen in combination with the options 3.1–3.3, the negative impact on cross-border activity by mortgage lenders in general, and product diversity in particular would be more pronounced, whereas the impact on consumer confidence would, in general, be more positive.

The impact of both Options 3.2–3.3 on the cross-border activity of mortgage lenders would generally be positive. However, given the more limited range of products under Option 3.3, the potential market could be slightly restricted. As such, the scope for cross-border activity under Option 3.3 could be slightly more limited. This overall effect is however uncertain.

While the impact of Option 3.3 on consumer confidence and consumer mobility is clearly positive, the aggregated impact of Option 3.2 on these two objectives cannot be determined at this stage because in those Member States, which currently have a right to early repayment, the impact will be negative while in those Member States, which have fully liberalised systems in place without any consumer safeguards, the impact will be positive.

In terms of timing, both Options 3.2–3.3 would require the initiation of a legislative process. Both options impose costs on Member States for the changing of their legislation with regard to early repayment. Under Option 3.3, some Member States would have to adapt their covered bond legislation too.

In conclusion, both Options 3.2–3.3 would be more effective than Option 3.1 or 3.4 to achieve the set objectives. However, a comprehensive qualitative and quantitative study would be necessary before the extent of the identified effects could be fully evaluated. Only then, would the Commission be able to establish which effects will dominate. On this basis, the Commission could then make its final decision as to which of the options discussed in this section provides the most benefits for all stakeholders concerned.

Table 20: Overview of policy option effectiveness

Option		Specific		General				Comments
		Ensure that consumers have an option to repay early at a fair and objective price and are not locked into their mortgage contract over the long term, particularly in unforeseen circumstances	Ensure that mortgage lenders are not restricted in offering the full range of products on their national markets and on a cross-border basis	**Cross-border activity**	**Product diversity**	**Consumer confidence**	**Consumer mobility**	
Option 3.1. Unconditional liberalisation of early repayment regimes (contractual option)	With liberalisation of early repayment compensation regimes (fair and objective)	–	+/++	+/++	+/++	–	–/≈	Not guaranteed that consumers would be protected in unforeseen circumstances and would not face the risk of long-term locking in.
	Caps (set below the level of actual costs incurred by mortgage lenders)	–	–/≈	–/≈	–/≈	–	–/≈	Higher prices for consumers. Not guaranteed that consumers would be protected in unforeseen circumstances and would not face the risk of long-term locking in.
Option 3.2. Liberalisation of early repayment regimes (contractual option) but with a right to early repayment in certain circumstances	With liberalisation of early repayment compensation regimes (fair and objective)	?	+/++	+/++	+/++	?	?	Overall impact on consumer confidence and customer mobility uncertain because in some Member States (with right to early repayment) impact will be negative and in some Member States (with fully liberalised systems) impact will be positive.

<table>
<tr><th rowspan="2" colspan="2">Option</th><th colspan="2">Specific</th><th colspan="4">General</th><th rowspan="2">Comments</th></tr>
<tr><th>Ensure that consumers have an option to repay early at a fair and objective price and are not locked into their mortgage contract over the long term, particularly in unforeseen circumstances</th><th>Ensure that mortgage lenders are not restricted in offering the full range of products on their national markets and on a cross-border basis</th><th>Cross-border activity</th><th>Product diversity</th><th>Consumer confidence</th><th>Consumer mobility</th></tr>
<tr><td></td><td>Caps (set below the level of actual costs incurred by mortgage lenders)</td><td>+</td><td>– –/–</td><td>–</td><td>–/≈</td><td>?</td><td>?</td><td>Higher prices for consumers. Overall impact on consumer confidence and customer mobility uncertain because in some Member States (with right to early repayment) impact will be negative and in some Member States (with fully liberalised systems) impact will be positive.</td></tr>
<tr><td rowspan="2">Option 3.3. Compulsory right to early repayment</td><td>With liberalisation of early repayment compensation regimes (fair and objective)</td><td>+</td><td>–/≈</td><td>+</td><td>–</td><td>+/++</td><td>≈/+</td><td>Higher prices for consumers. Less incentive for cross-border activity than other options because competition on a lower range of products.</td></tr>
<tr><td>Caps (set below the level of actual costs incurred by mortgage lenders)</td><td>+</td><td>– –/–</td><td>–</td><td>–/– –</td><td>+/++</td><td>≈/+</td><td>Higher prices for consumers.</td></tr>
</table>

Option		Specific		General				Comments
		Ensure that consumers have an option to repay early at a fair and objective price and are not locked into their mortgage contract over the long term, particularly in unforeseen circumstances	Ensure that mortgage lenders are not restricted in offering the full range of products on their national markets and on a cross-border basis	**Cross-border activity**	**Product diversity**	**Consumer confidence**	**Consumer mobility**	
Option 3.4. Mutual Recognition		–	≈/+	+/++	+/++	–/– –	–	Not guaranteed that consumers would be protected in unforeseen circumstances and would not face the risk of long-term locking in. Unequal level playing field between mortgage lenders from Member States with and without right to early repayment and caps on compensation

Assessment: ++ = strongly positive; + = positive; – – = strongly negative; – = negative; ≈ = neutral/marginal; ? = uncertain

3. PRODUCT TYING

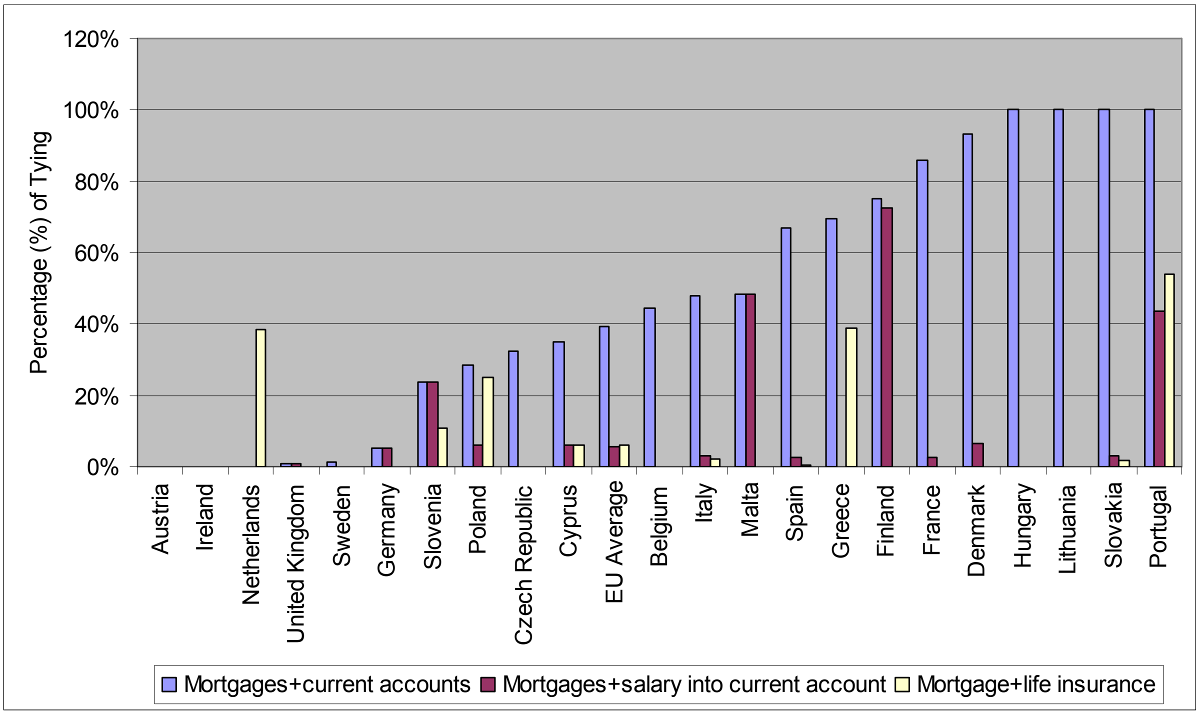
3.1. Context

Tying occurs when two or more products are sold together in a package, and at least one of these products is not sold separately.[114] Tying should not be confused with bundling where financial institutions sell two or more products together as a package at a discount despite each product being available separately.

114 Cf. footnote 14, p. 59; *Interim report II: current accounts and related services*, European Commission, 17.7.2006, p. 96.

A recent inquiry by the Commission[115] found significant levels of tying in the EU in retail banking. Tying is particularly prevalent in European mortgage markets. For example, on average 39% of new mortgage credits in the EU have current accounts tied to them. The incidence of tying life insurance to a mortgage credit or the payment of a salary into a current account is less common across the EU at 6% for each respectively.[116] These figures however mask national disparities.

Graph 10: Sampled banks reporting product tying, weighted by banks' combined % share of customer numbers in the mortgage product market (2005)



Source: Commission's *Final Report on the sector inquiry into retail banking*, p. 61 (Figure 11) and other data collected in the Commission's sector inquiry.

Tying has come to the attention of both competition authorities and regulators in several Member States. In Hungary, the competition authority (GVH) examined the issue of product tying in the mortgage market. Although the investigation found that one bank had a 52% share of the mortgage market, taking into account the intense competition and the decline in the leading bank's market share, it was found that the bank did not hold a dominant position. Evidence was found however of widespread tying in the mortgage market. The Hungarian competition authority found this tying unjustified and recommended to the supervisor that the practice of mortgage tying should be prohibited or restricted.[117] In Ireland, a new Consumer Protection Code was issued in July 2006 prohibiting the tying of all financial services products to customer.[118] However, unless all Member States engaged in any action at the national level, tying would continue to distort European mortgage markets.

115 Cf. footnote 14, p. 61.

116 Cf. footnote 14, p. 61; *Interim report II: current accounts and related services*, European Commission, 17.7.2006, p. 109.

117 Cf. footnote 14, p. 66.

118 Article 4 of Consumer Protection Code, Irish Financial Services Regulator, August 2006.

Following on from the sector inquiry into retail banking, the Commission is also currently looking into the practice of tying across the retail financial services sector.

3.2. Problem description

Many mortgage lenders argue that product tying is beneficial as it reduces their credit risk by enabling them to monitor the customer's finances more efficiently. They also argue that tying can also bring economies of scope and can enable the financial services provider to offer two products together more cheaply than could be done if they were provided separately, thereby benefiting consumers.[119] However, it is important to emphasise that while such benefits can be obtained both through bundling and product tying, with bundling, the choice to purchase the second product lies with the consumer whereas with tying, consumers are forced to purchase additional and perhaps unnecessary products. In this context, product tying creates several problems for the efficient functioning of European mortgage market.

First, product tying binds consumers to a particular financial services provider by raising switching costs. Consumers wishing to switch mortgage providers may have to open a current account with the new provider and may have to switch the destination of their salary to that account. The extent to which this practice is prevalent varies considerably across the EU (see Graph 10 above), ranging from 0% in some countries (e.g. Austria, Ireland and the Netherlands) to 44% in Portugal, 48% in Malta, and 72% in Finland.[120] This acts as a strong deterrent to shopping around cross-border.[121] With their salary at a new financial institution, consumers may also feel obliged to undertake their daily financial transactions, such as payments with the new provider. In such circumstances, direct debits have to be reorganised, etc. Thus switching mortgage providers may lead to a complete reorganisation of an individual's daily financial arrangements. Such a change may be costly in terms of time and effort but may also be costly financially if, for example, closing fees are imposed. Consumers who have a full range of financial services at one provider are therefore less likely to switch mortgage lenders if one product is tied to another. As a consequence, customer mobility is limited and competition is restricted.

Tying not only has implications for customer mobility but can further reduce the price and product competition in the markets for the tied and tying product by discouraging the entry of new players, particularly those financial services providers specialising in the tied product. For example, a mono-line provider of life insurance would find it more difficult to capture market share where such products were typically tied to a mortgage credit. Mortgage credit providers seeking entering the market may however also encounter difficulties in attracting customers due to the existence of high switching costs for consumers. As such, cross-border activity by mortgage credit providers may be deterred.

Finally, a key factor in promoting customer mobility is price transparency. Product tying reduces price transparency and comparability among providers. This is particularly difficult for mortgage credit products for various reasons. Not only are mortgage products complex and the information available is often presented in complex technical and financial terms but also the pricing structure of products may not necessarily provide accurate signals. For example, mortgage markets are typically quite competitive with considerable pressure on

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119 Cf. footnote 14, p. 65.

120 Commission calculations based on data collected for the Commission's sector inquiry into retail banking.

121 The Commission has received several letters of complain about this practice.

interest rates. However, customers are typically also required to take out current accounts for which prices are much less transparent. Thus, it is difficult for customers to be sure that they are accepting the best deal.

Table 21: Problems and consequences

Problem	Consequences
Product tying	For mortgage lenders and providers of tied products: – Discourages the entry of new players (both domestic and cross-border), particularly mono-line providers => Reduced competition in tied and tying product markets For consumers: – Raises switching costs – Reduces price transparency and comparability amongst providers. => reduced customer mobility => weakened competition

3.3. Stakeholder's views

3.3.1. Consumers

Consumers have identified tying as one of the main impediments to increased customer mobility.[122] Consumers argue that there are very strong incentives for lenders to tie in consumers with a mortgage credit in order to cross-sell other products, inhibiting customer mobility, thus restricting market entry and competition. Consumers argue that binding measures to deal with 'tying in' of consumers and bundling of products should be the priority.[123] At the same time, consumers argue that even if the tying of products is forbidden, consumers could be strongly advised to acquire another product if they wish to purchase it under specific conditions. It is complicated to prove that consumers have been obliged/strongly advised to purchase an accessory product alongside the 'main' product (e.g. purchasing an insurance policy alongside a mortgage credit to secure a better interest rate, which results in effective tying). Consumers therefore argue that it would have to be ensured that consumers can easily terminate the contract (timing, limited termination fees) for an individual part of the 'bundle' without necessarily calling into question the conditions for the other product(s).

122 *Summary of the Written Contributions received on the Green Paper on Retail Financial Services*, 18.9.2007, p. 18, http://ec.europa.eu/internal_market/finservices-retail/docs/policy/gp_report-2007_09_18_en.pdf.

123 Response of the European Consumers' Organisation (BEUC) to the Green Paper on Retail Financial Services, 23.7.2007, p. 29, http://ec.europa.eu/internal_market/finservices-retail/docs/policy/gp_comments/user_eu_beuc_en.pdf.

3.3.2. Mortgage lenders

As said previously, many mortgage lenders argue that product tying is beneficial as it reduces their credit risk by enabling them to monitor the customer's finances more efficiently. They also argue that tying can also bring economies of scope and can enable the financial services provider to offer two products together more cheaply than could be done if they were provided separately, thereby benefiting consumers.[124]

3.4. Objectives

The Commission seeks to promote competition in European mortgage markets by encouraging customer mobility and the cross-border provision of services by mortgage lenders.

Specifically, it should be ensured that product tying or other similar practices do not inhibit the free movement of services throughout the European Union.

3.5. Description of options

3.5.1. Option 1: Do nothing

Customer mobility would remain restricted and new entrants would face difficulties in entering the market. Competition would be limited. However, some Member States, such as Hungary and Ireland, have recognised product tying practices on their national markets as a problem and are taking or recommending action to address this issue.

3.5.2. Option 2: Self-regulation

Self-regulation can be implemented in two ways. First, mortgage lenders could commit, via a Code of Conduct, not to tie current accounts or life insurance policies to mortgage products. They could also commit to not obliging consumers to have their salary paid into the current account. This voluntary agreement could be incorporated into the existing Voluntary Code of Conduct on Pre-contractual Information for Home Loans. However, it could also be a stand alone commitment by the mortgage lending industry not to engage in product tying. Second, a horizontal Code of Conduct to prohibit tying of all financial services products (not just mortgage products) could be envisaged. This would however require further research as to the extent of tying of other retail financial services products. Moreover, it goes beyond the scope of mortgage credit. As such only the impact of a Code of Conduct on mortgage credit markets will be examined here.

3.5.3. Option 3: Legislation

The Commission could introduce legislation in two ways. First, it could prohibit or limit tying to mortgage products. Second, it could adopt a horizontal legislative instrument prohibiting or limiting tying to other financial services products in general. This legislative instrument could also eventually contain the prohibition/restriction of other similar practices in the area of retail financial services. This would however require further research as to the existence of unfair commercial practices in all retail financial services products. Moreover, it goes beyond the scope of mortgage credit. As such only the impact of legislation on mortgage credit markets will be examined here.

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[124] Cf. footnote 14, p. 65.

3.5.4. Option 4: Enforcement of EU competition law

Product tying by one or more undertakings in a particular Member State may constitute an exclusionary abuse under Article 82 of the EC Treaty, where such undertakings have a dominant position in a product market that is subject to tying. However, the enforcement of competition law is only possible on a case-by-case basis. For product tying to be regarded as an exclusionary abuse of dominance, it would need to be proven that the supplier is dominant in the lead market and that tying practice is likely to distort or foreclose competition in the tied product market, for example in the current account market or in the life insurance market. As such, the enforcement of EU competition law would be unable to change the practices of all mortgage credit providers. In markets where there is no dominant mortgage credit provider, the tying of products to mortgage credits is therefore likely to remain. Furthermore, given that the practice of obliging customers to have their salary paid onto the current account where their mortgage credit is based does not strictly fall under the tying definition outlined above, EU competition law would be unable to impact on the use of this practice.

In conclusion, independent of the outcome of the investigations into whether there is an abuse of a dominant position, the enforcement of EU competition law is not capable of addressing the problems identified in connection with tying sufficiently.

3.6. Impact assessment

3.6.1. Option 1: Do nothing

The national initiatives could help to reduce the level of tying in the mortgage markets in Hungary and Ireland. Besides those two Member States, tying would continue to distort most of the European mortgage markets. However, based on the findings of the Commission's sector inquiry into retail banking, other Member States could in theory follow the example of Hungary and Ireland to take measures on the national level to restrict tying on their national markets. Such measures would benefit consumer mobility and increase competition between mortgage lenders through the market entrance of new competitors. However, unless all Member States engaged in any action at the national level, tying would continue to distort European mortgage markets.

Member States would face costs for taking measures against tying, e.g. for the introduction of anti-tying legislation.

Table 22: Impacts of Option 1

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Do nothing	Consumers	≈/+ freedom to contract financial services with the provider of their choice but some practices may still remain (D) ≈/+ potential for increased customer mobility (D) ≈/+ lower prices as a result of more competition (new entrants and increased mobility) (I)	Medium to long term	Dynamic	Medium (dependent on level of action taken by Member States)
	Mortgage lenders (D)	? overall effect uncertain (≈/+ for new entrants; –/≈ for mortgage lenders who currently tie products but would have to amend their current processes)	Medium to long term	Dynamic	Medium (dependent on level of action taken by Member States)
	Providers of the products tied to mortgage credit	≈/+ for new entrants	Medium to long term	Dynamic	Medium (dependent on level of action taken by Member States)
	Member States (D)	– costs for taking measures against tying	Medium to long term	Dynamic	Medium (dependent on level of action taken by Member States)

3.6.2. Option 2: Self-regulation

A Code of Conduct could potentially remove the problems associated with product tying and open up markets.

However, the voluntary nature of the Code implies that mortgage lenders could not be obliged to subscribe to and implement the Code. The overall impact of the Code would therefore be dependent on to what extent mortgage lenders would actually adhere to the Code as well as to what extent it would actually be enforced. This would be a particular problem for a Code prohibiting tying as mortgage lenders argue that product tying is beneficial as it reduces their credit risk by enabling them to monitor the customer's finances more efficiently. The incentive for mortgage lenders to adhere to such a Code is therefore limited. As such, the persistent lack of comparability between different offers would mean that customer mobility remains impaired as the search costs associated with comparing different products would remain high. Consumers would also face uncertainty as to what they could expect from individual banks.

In the event that mortgage lenders adhered to such a Code, consumers would no longer be bound to a particular mortgage lender by a range of different products. Although not strictly within the definition of tying, such a Code could also potentially contain provisions prohibiting the requirement for the salary to be paid into a current account with the mortgage lender. This would enable those customers who wish to switch providers to do so more easily and with lower search costs, thus increasing competition. The size of this impact would however be dependent on the extent to which consumers would be interested in switching. The benefits to consumers would not be equally throughout the EU. Consumers in countries where tying is prevalent, such as Slovakia, Portugal, Latvia, and Hungary would have the most potential for benefits where as consumers countries where there is more limited tying, such as Austria or Ireland, would feel less of an impact.

In addition to the level of adherence, the eventual impact of a Code prohibiting tying on mortgage lenders would depend on the balance between two impacts. On the one hand, mortgage lenders would have to re-evaluate their risk assessment models and develop alternative means of evaluating consumer credit risks. On the other hand, the greater openness of the market would provide mortgage credit providers both domestically and cross-border with the opportunity to enter the market and attract consumers, thus providing a further boost to competition.

By reducing tying in mortgage credit markets, overall market transparency, i.e. for current accounts and other tied products, would also be enhanced and consumers would be able to compare products between providers more easily, not only in mortgage credit markets but also for other financial services products.

Table 23: Impacts of Option 2

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Self-regulation – adoption of a Code of Conduct	Consumers (D)	≈/+ freedom to contract financial services with the provider of their choice but some practices may still be remain (D) ≈/+ ↑ potential for increased customer mobility (D) ≈/+ ↓ prices as a result of more competition (new entrants and increased mobility) (I)	Short to long term	Dynamic	Low to medium (dependent on the level of adherence to the Code)
	Mortgage lenders (D)	? dependent on the level of adherence to the Code: => ≈/+ for new entrants (I) => –/≈ for mortgage lenders who currently tie products but would have to amend their current business strategy (D)	Medium to long term	Dynamic	Low to medium (dependent on the level of adherence to the Code)

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
	Providers of the products tied to mortgage credit (I)	≈/+ for new entrants (I)	Medium to long term	Dynamic	Low to medium (dependent on the outcome of investigations by the Commission)
	Member States (I)	≈ (I)	n.a.	n.a.	Certain

3.6.3. Option 3: Legislation

The introduction of binding legislation could remove the problems associated with product tying and open up markets. Mortgage lenders could be prohibited from engaging in tying or from obliging customers to have their bank account paid into a current account with the mortgage lender.

Consumers would no longer be bound to a particular mortgage lender by a range of different products. This would facilitate the comparison of different products and enable those customers who wished to switch providers to do so more easily and with lower search costs, thus increasing competition. The size of this impact would however be dependent on the extent to which consumers would be interested in switching. The benefits to consumers would not be equally spread throughout the EU. Consumers in countries where tying is prevalent, such as Slovakia, Portugal, Latvia, and Hungary would have the most potential for benefits where as consumers countries where there is more limited tying, such as Austria or Ireland, would feel less of an impact.

All mortgage lenders would have to comply with the legislation, thus a level playing field would be created. Mortgage lenders would face costs in the re-development of their risk assessment models, however the improved competitiveness of the market would create new business opportunities for both domestically and cross-border mortgage credit providers. The net impact in terms of costs on mortgage lenders of the adoption of binding legislation is however difficult at this stage to clearly establish.

The introduction of binding legislation prohibiting tying in mortgage credit markets would contribute to overall market transparency, i.e. for current accounts and other tied products, thus facilitating the comparison of a wide range of products by consumers.

Member States would face one-off costs of implementing the legislation as well as ongoing costs of enforcement.

Table 24: Impacts of Option 3

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Legislation	Consumers (D)	+/++ freedom to contract financial services with the provider of their choice (D) +/++ ↑ potential for increased customer mobility (D) +/++ ↓ prices as a result of more competition (new entrants and increased mobility) (I)	Short to long term	Dynamic	Medium to high
	Mortgage lenders (D)	? dependent on the balance between: => ≈/+ for new entrants (I) => –/≈ for mortgage lenders who currently tie products but would have to amend their current business strategy (D)	Short to medium term	Dynamic	High
	Providers of the products tied to mortgage credit (I)	≈/+ for new entrants (I)	Short to medium term	Dynamic	High
	Member States (D)	– ↑ costs for implementing legislation (D)	Short to long term	Static and dynamic	Certain

3.7. Comparison of options

Option 1 is already underway in some Member States. However, there is no guarantee all Member States would launch initiatives against tying. A choice for Option 2 would represent an important signal as to the future credibility of self-regulation in the field of retail financial services. Potentially, self-regulation could offer a quick and easy solution, however the reality is that the development of a Code are likely to be extremely resource consuming for all involved. A decision for Option 3 would however also require some time. The necessary process and the legislative process would mean that any changes would not enter into effect for several years.

The key difference between the different options is that Options 1 or 2 cannot completely prevent the preponderance of tying in certain Member States whereas Option 3 can. For Option 2 to be a success, adherence to and implementation of the Code would have to be as good as under binding legislation. Such adherence might however be questionable given the incentive of banks to continue tying in order to minimise their credit risks and increase cross-selling. Credible and independent monitoring and enforcement mechanisms would also need to be established. Option 3 is therefore the most effective option to ensure that tying is prohibited across all EU Member States thereby creating a level playing field for mortgage lenders and consumers alike.

All options outlined would result in costs for those mortgage lenders, which currently use tying practices, in terms of re-developing their risk assessment models. However, all options also present domestic and cross-border mortgage lenders with opportunities in terms of being able to attract new business market. The net impact in terms of costs on mortgage lenders of the adoption of binding legislation is however difficult at this stage to clearly establish. Member States would also face costs for implementing legislation.

In conclusion, while Options 1–2 have the potential to bring the desired results to segments of the market or certain Member States, both incur the risk that the practice of tying may continue to exist amongst certain mortgage credit providers or certain countries, limiting competition both domestically and cross-border. However, when comparing the potential for effectiveness of Option 1 and 2, it has to be acknowledged that only very few Member States are currently addressing tying and that, according to the information currently available, it seems to be highly unlikely that the majority of Member State will act accordingly in the near future. Option 2 appears therefore to have more potential to achieve the objective. Option 3 would offer borrowers and mortgage lenders alike, certainty about what can and cannot be done. In terms of the speed of implementation, Options 2–3 are likely to be similarly effective in terms of timing. Against this background, Option 1 can be discarded in favour of Options 2–3.

A crucial aspect to consider however in the development of the Commission's future policy in this area is the potential benefits to retail financial services markets of limiting tying in general. Abolishing tying to mortgage credit products would have knock-on consequences for other retail financial services products such as current accounts and life insurance. Furthermore, certain practices, such as the practice through which consumers are obliged to have their salary paid into the current account with their mortgage provider, fall outside of the definition of the definition of tying used in this analysis. This wider impact on retail financial services markets, together with the fact that tying also exists for other retail financial services products, e.g. tying of a current account to an insurance policy, illustrates that a more horizontal approach may be justified. Further research on the extent to which product tying is prevalent in other product markets is required.

Table 25: Overview of policy option effectiveness

Option		Specific objective	General objectives				Comments
		To ensure that product tying does not inhibit the free movement of services throughout the EU	Cross-border activity	Product diversity	Consumer confidence	Consumer mobility	
1	Do nothing	≈/+	≈/+	≈	≈	≈/+	Dependent on level of action taken by Member States.
2	Self-regulation – adoption of a Code of Conduct	≈/+	≈/+	≈	≈	≈/+	Dependent on the number of banks adhering to the Code of Conduct.
3	Introduce binding legislation	+/++	+	≈	≈/+	+/++	Final impact would depend on the content of the legislation and the outcome of the co-decision procedure.

Assessment: ++ = strongly positive; + = positive; – – = strongly negative; – = negative; ≈ = neutral/marginal

4. CREDIT REGISTERS

4.1. Context

Credit registers operate in all EU Member States except one (Luxembourg). Credit registers collect financial data on individuals in order to provide credit data to mortgage lenders and other credit providers to address information asymmetries and set prices for potential borrowers.

European credit register markets are structured along three main lines: public[125], private[126] and markets where both public and private credit registers exist[127]. This variety of structures reflects several factors including different policy objectives (such as financial stability or combating overindebtedness), different attitudes towards personal data, the development of the credit market, and the existing legal and regulatory framework. In general, public credit registers are operated by national central banks on a non-profit basis. Reporting to public credit registers is a legal obligation. Private credit registers have varied membership structures and are mainly for-profit.

125 For example, Belgium and France.

126 For example, Denmark, Estonia, Finland, Greece, Cyprus, Hungary, Ireland, Malta, Netherlands, Poland, Sweden and the UK.

127 For example, Austria, Bulgaria, Czech Republic, Germany, Italy, Latvia, Lithuania, Portugal, Romania, Slovakia, Slovenia and Spain.

The data collected by credit registers is diverse. In some countries, such as Belgium, Spain and the UK, both positive and negative information is collected whereas in other countries, such as France, only negative data is collected.[128] For public credit registers, the reporting threshold (the value above which credits must be declared) can also vary considerably ranging from EUR 50 in Portugal to EUR 1 500 000 in Germany.[129]

The regulatory framework for credit data sharing is based on national legislation on banking and credit reporting as well as national legislation implementing the EU Data Protection Directive[130].

Credit registers remain nationally based with only a few credit registers engaging in cross-border activity. One large credit register estimated that cross-border requests amounted to only 0.05% of the total number of requests for information received. The low levels of cross-border activity can be attributed both to the low level of demand and supply for information as well as the presence of regulatory barriers. Several initiatives have been launched to develop cross-border data sharing. The Association of Consumer Credit Information Suppliers (ACCIS) developed a model contract for cross-border data exchange to assist its members in the cross-border provision of information. Credit registers from a few countries, such as Germany and the Netherlands, have signed such agreements. Under the auspices of the European System of Central Banks, in 2003, seven Member States[131] signed a Memorandum of Understanding on the cross-border exchange of data through the network of public registers, which entered into force from mid-June 2005.[132] The Memorandum of Understanding currently covers data relating to lending to corporate customers where the value of the credit exceeds EUR 25 000. At present, the Memorandum of Understanding does not address the cross-border exchange of information on loans to individuals.[133]

4.2. Problem description

Mortgage lenders do not depend solely on credit registers to obtain information on their customers. The access to and the availability of credit data is however an important factor in a competitive banking market and has consequences for both mortgage lenders and consumers.

For mortgage lenders, the inability to access complete credit data in general may impede the ability of new mortgage lenders – be they domestic or foreign – to compete for customers. In pricing the products, mortgage lenders take into account consumer's credit risks. Mortgage lenders who are unable to access credit data or are only able to obtain incomplete data may therefore price the product incorrectly by under- or overestimating the consumer's credit risk (adverse selection). By overestimating a client's credit risk, and thus charging a higher interest rate, mortgage lenders face a competitive disadvantage vis-à-vis mortgage lenders who have more complete information. In such circumstances, consumers may face higher costs. By underestimating a client's credit risk, and thus charging a lower interest rate, the mortgage

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128 Positive information describes total amounts and types of loans, accounts currently open and active, balances and credit limits. Negative information refers to defaults (late payments, arrears and bankruptcies).

129 Cf. footnote 14, p. 37.

130 Directive 95/46/EC, 24.10.1995.

131 Austria, Belgium, France, Germany, Italy, Portugal and Spain.

132 http://www.bundesbank.de/download/presse/pressenotizen/2005/20050607bbk1_en.pdf.

133 http://www.bundesbank.de/download/presse/pressenotizen/2005/20050607bbk1_en.pdf.

lender may face unexpected losses. The existence of these information asymmetries may deter market entrants.[134] Credit data sharing can also act as a borrower discipline device by reducing a consumer's incentive to default since in a market with credit data sharing, the default would be widely known and a consumer's reputation with other mortgage lenders would be damaged.

For consumers, the extent of credit data sharing impacts on their mobility. For example, consumers seeking to take out a loan cross-border may face higher prices or be denied the opportunity due to the fact that the foreign mortgage lenders are unable to access sufficient information on the consumer's credit history. The extent of credit data sharing has also an impact on EU citizens who move across borders to work or to enjoy their retirement. More than 15 million EU citizens have used their right to work and live abroad up to now.[135] Because credit histories are not portable between Member States, those citizens face the same problems as consumers seeking to take out a loan cross-border in terms of potentially higher prices for credit or the risk of being denied credit until they have build up a credit history abroad.

The problem of access to and availability of credit data is caused by two main factors: unfair access conditions and incomplete credit information.

4.2.1. Unfair or discriminatory access conditions

Both public and private credit registers require their members and/or clients to meet certain conditions. These broadly fall into two categories: conditions relating to the membership/client criteria and those relating to fee structure. Membership and/or client criteria include, for example, undertaking credit granting activity, holding a banking license, having a physical presence in the Member State, compliance with reciprocity agreements, and compliance with data protection laws.

Charges for accessing credit data vary with one-off joining fees, ongoing membership fees and per-transaction fees for consultations evident across Europe. Joining fees can range from EUR 0 for public and some private credit registers to in excess of EUR 1 000 for some private credit registers – as much as EUR 75 000 in one instance. Transaction fees range from EUR 0 to around EUR 2. The cost of consultation may however vary according to usage (volume based pricing): one private credit register has reported that its average transaction fee varied from EUR 0.46 to EUR 10.95 depending on use.

While some of the conditions set may be justifiable, unfair or discriminatory access conditions may prevent mortgage lenders from other Member States from offering their products across Europe in several ways. First, the need to have a physical presence in the Member State[136] means that foreign mortgage lenders would be unable to access credit data should they wish to. This places them at a competitive disadvantage vis-à-vis domestic mortgage lenders. Second, the need to hold a banking license may also act as a barrier, in particular to non-banks seeking to enter the market.[137] Third, excessively high joining or

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[134] Cf. footnote 14, pp. 35 and 44.

[135] SEC(2007) 1521, 20.11.2007, p. 3, http://ec.europa.eu/citizens_agenda/docs/sec_2007_1521_en.pdf.

[136] For example, the credit registers of the Austrian Central Bank, Bank of Spain, Bank of Portugal and the Bank of Latvia.

[137] The requirement to hold a banking license in order to engage in mortgage lending and the resulting obstacles will be discussed in more detail in Section 11.

transaction fees may deter foreign mortgage lenders from joining the credit register thus reducing the contestability of clients of the incumbent banks. Volume based pricing may also deter consultations by foreign mortgage lenders who lack the critical mass of mortgage loans to reduce costs. Finally, although the EU Data Protection Directive has been implemented by all Member States, and consequently, data protection rules should not act as an obstacle to cross-border information flows, according to research by the Commission[138] in a small number of Member States, problems can arise in relation to compliance with national data sharing rules when, for example, negotiating reciprocity agreements.

4.2.2. Incomplete credit information

Complete credit information reduces information asymmetries between mortgage lenders and consumers, limiting the information advantage of incumbent mortgage lenders with large market shares who have access to a wide range of information on their clients, thus enabling the development of more accurate risk scoring and pricing models.

Incomplete credit information can arise for five main reasons.

First, as noted above, reporting thresholds vary considerably between credit registers. This means that the credits reported differ between registers. Hypothetically, a mortgage credit of EUR 25 000 may be entered in one credit register but not in another.

Second, the definitions used by credit registers are different, for example, payment defaults and delinquencies. As such, a consumer classified as in default in one Member State may not necessarily be classified – under the same circumstances – as in default in another Member State.

Third, the information available in credit registers may not contain all the information that it should. In case of some private credit registers, reporting is voluntary. According to research by DG Competition, some private credit registers may accommodate larger banks by waiving the requirement of full disclosure of data. The enforcement of the principle of reciprocal data sharing could also be problematic in these cases. Where full disclosure is a legal obligation (in case of public and certain private credit registers) incomplete reporting by mortgage lenders should not arise. However, even then, reporting entities may not report everything that they are agreed or obliged to. According to research by the Commission[139] in a small number of Member States, problems arise in relation to compliance with national data sharing rules. For example, the sector inquiry reports of instances where credit registers do not exercise close scrutiny of the information provided by their members or the members fail to provide complete information on their clients.[140]

Fourth, some credit registers collect only negative data whereas others collect both positive and negative data. The scope of data collected is often regulated by national law. The availability of only negative information may place competitors at a disadvantage by obscuring consumer's real credit risk and raising the prices for consumers.[141]

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138 Cf. footnote 14, p. 48.
139 Cf. footnote 14, p. 48.
140 Cf. footnote 14, p. 48.
141 Cf. footnote 14, p. 35.

Finally, the information stored about a consumer in a credit register may be incorrect or outdated. Wrong data, which can also be seen as incomplete information about a consumer, can impose a serious problem for mortgage lenders and consumers because it does not allow for an accurate risk scoring and therefore leads to wrong pricing or, in the worst case, to the rejection of a financially sound consumer.

Table 26: Problems and consequences

Problem	Consequences
Access to and quality of customer credit data ▪ Unfair or discriminatory access to credit registers (membership criteria, high joining fees, etc.) ▪ Incomplete credit information (different definitions, reporting thresholds, positive/negative data, wrong data, etc.)	For consumers: – Mobility is limited => competition is restricted. – Access to mortgage credit is limited – Higher prices For mortgage lenders: – inability to completely and accurately access risks => prices may be higher as mortgage lenders cover their risks. => increases the risk of adverse selection (i.e. providing loans to customers who are unable to obtain a loan elsewhere). => mortgage lenders may decide against offering credit. – High cost of accessing credit data => lack of economies of scale mean that the cost per transaction is higher => higher prices. => mortgage lenders may decide against offering credit.

4.3. Stakeholder's views

4.3.1. Consumers

Half of consumer organisations responding to the consultation on the Green Paper on Mortgage Credit supported the idea of cross-border access to credit registers on a non-discriminatory basis.[142] However, consumers expressed their concerns about the security, access and use of data.[143] In their view, it is important to ensure that information is only used to facilitate credit assessment and not for marketing or commercial prospecting. They argue that any system would have to provide customers with the opportunity, free of charge, to correct the information held on them in any register. In addition, when a database is accessed, the user should be permitted to get details of who accessed it and the purpose of the request.

142 Cf. footnote 35, p. 34.
143 Cf. footnote 122, p. 18.

Some consumer groups were of the view that the databases or registers should not include positive information while others felt that the inclusion of positive information would benefit users.

4.3.2. Mortgage lenders

The large majority of mortgage lenders are in favour of cross-border access to credit registers on a non-discriminatory basis.[144] Mortgage lenders argue that access to credit registers can facilitate cross border activity because it allows lenders to enter markets with greater confidence and to price their products or services more accurately.[145] Some mortgage lenders believe that a memorandum of understanding would be the most appropriate means of granting access to credit information. However, concerns where raised that the data privacy requirements set out in EU Directives and national laws may require primary legislation before a memorandum of understanding across borders is feasible.[146]

4.3.3. Member States

The majority of Member States also support the idea of cross-border access to credit registers on a non-discriminatory basis.[147] Member States are of the opinion that data protection issues need to be taken into account when discussing the access to and the use of credit data. Views are mixed as to whether a Memorandum of Understanding between credit registers would be a solution, the need for a common set of standards, and the collection of positive data.[148]

4.4. Objectives

The Commission seeks to ensure non-discriminatory access to credit registers and encourage more complete information.

4.5. Description of options

4.5.1. Option 1: Do nothing

Current problems persist and competition would stay restricted. Mortgage lenders would remain reluctant to enter new markets due to the difficulties in obtaining the relevant information to properly assess risks. Consumer mobility would remain restricted as foreign mortgage lenders are unable to match domestic mortgage lender's informed risk-based pricing. This option can therefore be discarded already at this stage.

4.5.2. Option 2: Full and active enforcement of existing EU rules

A full and active enforcement of existing legislation both at the European and national level may address the problems. For example, infringement cases could be considered in cases where there is a clear breach of European Internal Market rules.

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144 Cf. footnote 35, p. 34.

145 Cf. footnote 122, p. 18.

146 Cf. footnotes 35, p. 34 and 122, p. 18.

147 Cf. footnote 35, p. 34, and comments provided by members of the Government Expert Group on Mortgage Credit: http://ec.europa.eu/internal_market/finservices-retail/home-loans/gegmc_comments_en.htm.

148 See comments provided by members of the Government Expert Group on Mortgage Credit: http://ec.europa.eu/internal_market/finservices-retail/home-loans/gegmc_comments_en.htm.

4.5.3. Option 3: Improve cooperation between credit registers (self-regulation)

With direct access to credit registers complicated and sometimes costly, indirect access could be another option for mortgage lenders seeking to operate cross-border. In such cases, a mortgage lender seeking to offer a loan in another EU Member State, would contact its domestic credit register to ask it to contact the credit register in the other Member State for information on the customer. For this to operate however, the credit register needs to be part of a bilateral or multi-lateral agreement (e.g. Memorandums of Understanding).

A mortgage lender receiving a credit report from another Member State has, however, no guarantee that the information received will be the same as the information it has domestically due to the existence of different standards and thresholds. Cooperation between credit registers could be further enhanced through a Dialogue on the standards for data included in credit registers.

In order to ensure reliability of credit information stored in databases, self-regulation could also develop mechanisms to involve consumers in the monitoring of the correctness of the information stored.

4.5.4. Option 4: Legislation

Legislation could be introduced covering a range of the abovementioned issues. For example, a legal obligation to ensure cross-border non-discriminatory access could be proposed to address the existence of discriminatory access conditions as foreseen in Article 9(1) of the proposed Consumer Credit Directive[149]. Another example could be binding rules obliging credit registers to collect both positive and negative data and ensure full data disclosure. Furthermore, mirroring the Article 9(2) of the proposed Consumer Credit Directive[150], mortgage lenders could be obliged to inform the consumer immediately and without charge of the result of the consultation of a credit register if the rejection of the credit application is based on the consultation of this credit register. To further ensure the correctness of the stored information, credit registers could be obliged to provide consumers on a regular basis, for instance once a year, with a document which contains their stored data in order to give consumers the chance to correct those data.

4.5.5. Option 5: Establish a pan-EU credit register

The Forum Group on Mortgage Credit considered the establishment of a European Credit Register as a means to address the multiplicity of credit registers (public/private) and the information stored by them (negative/positive). All credit providers would be able to access the same standardised information on equal terms. However, a number of issues would have to be addressed before the idea of a pan-European credit register could be considered, for instance questions with respect to the availability of data, liability for the data and supervision of such a register. In addition, such a register would have a negative impact on existing private credit registers because there is a risk that they lose their business with the establishment of a pan-EU credit register which can be accessed by all credit providers. Furthermore, the establishment, operation and monitoring of such a register would be

[149] Common Position adopted by the Council with a view of the adoption of a Directive of the European Parliament and of the Council on credit agreements for consumers and repealing Council Directive 87/102/EEC (9948/2/2007).

[150] Cf. footnote 149.

expensive. Against this background, this option can therefore be discarded already at this stage.

4.6. Impact assessment

4.6.1. Option 2: Enforcement of existing EU rules

Infringement cases in cases of a clear breach of European Internal Market rules could help to address the issue of unfair or discriminatory access conditions.

The outcome of the investigations would determine to what extent unfair or discriminatory access conditions could be abolished. Mortgage lenders will benefit from better accessibility of credit registers. However, even when being able to access a credit register, mortgage lenders would continue to face incomplete credit information which can lead to an incorrect assessment of consumer's credit risks. As a consequence, customer mobility would be restricted and consumers could still face higher prices for their mortgage products or be excluded from taking out a credit.

Table 27: Impacts of Option 2

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Enforcement of existing legislation	Consumers (I)	≈/+ ↓ prices (I) ≈ on the accuracy of consumer's personal data (I) ≈/+ ↑ customer mobility (I)	Medium to long term	Dynamic	Uncertain (depending on outcome of investigations)
	Mortgage lenders (D)	≈/+ ↓ information asymmetries (D) ≈/+ accessibility of credit registers (D) ≈ incomplete credit information (D)	Medium to long term	Dynamic	Uncertain (depending on outcome of investigations)
	Credit registers (D)	– ↑ costs for amending access conditions (D)	Medium to long term	Dynamic	Uncertain (depending on outcome of investigations)
	Member States (D)	– ↑ costs for change of legislation on access conditions (if credit registers are publicly owned) (D)	Medium term	Static	Uncertain (depending on outcome of investigations)

4.6.2. Option 3: Improve cooperation between credit registers (self-regulation)

The development of Memorandums of Understanding between credit registers would in principle enhance the accessibility of foreign credit registers for mortgage lenders through indirect access possibilities. A Dialogue between credit registers could theoretically ensure that the exchanged information will be comparable. The active involvement of consumers in the correction and updating of stored information could further improve the provision of complete credit information, thereby enabling the development of more accurate risk scoring and pricing models. Consumers would be encouraged to shop around for better offers and benefit from prices which accurately reflect their credit risks and will not be excluded from access to credit on an unjustified basis. The ability of consumers to switch providers to obtain a better offer would therefore be facilitated.

Some credit registers might however not willing or not be able to take part in such an initiative. Private registers, which are for-profit, may not have an incentive to share their data with other private registers because they perceive themselves as competing entities. In addition, credit registers might not see the need to engage in a self-regulatory process with the view to enhance cross-border access because, according to information provided to the Commission, the number of cross-border inquiries is currently low compared to national inquiries.[151] Certain public registers might be unable to participate in the near future because there are currently restrictions in their national legislation which prevent participation. Member States operating public registers which face such restriction might face costs for amending their framework to abolish such restrictions. Any Memorandums of Understanding might therefore not cover all 27 Member States, therefore impacting on the benefits for mortgage lenders and consumers.

Credit registers would face costs for engaging in the self-regulation process. These costs might be passed on to mortgage lenders using the possibility of indirect access through higher fees for this service which in turn could pass their costs to consumers. However, the benefits for consumers from a better risk assessment of their credit risk for a mortgage loan would certainly outweigh these costs.

Table 28: Impacts of Option 3

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Self-regulation	Consumers (I)	≈/+ ↓ prices (I) ≈/+ on the accuracy of consumer's personal data (I) ≈/+ ↑ customer mobility (I)	Medium to long term	Dynamic	Low to medium
	Mortgage lenders (D)	≈/+ ↓ information asymmetries (D) – ↑ costs for engaging in self-regulation (D) + ↑ accessibility of credit registers through indirect access (D) + ↑ complete credit information (D)	Medium to long term	Dynamic	Medium to high
	Credit registers (D)	– ↑ costs for engaging in self-regulation (D) + ↑ accessibility of credit registers through indirect access (D) + ↑ complete credit information (D)	Medium to long term	Dynamic	Medium to high
	Member	≈/– ↑ costs for amending	Medium term	Static	Low to medium

151 For example, in Germany, annual cross-border inquiries account for approximately 0.05% of annual national inquiries.

	States (D)	framework on credit registers for some Member States (D)			

4.6.3. Option 4: Legislation

By proposing legislation which obliges Member States to ensure for mortgage lenders access to credit registers at non-discriminatory conditions, the Commission would be ensuring a consistent approach with the proposed Consumer Credit Directive. This provision would ensure that all mortgage lenders enjoy non-discriminatory access to credit registers. In addition, theoretically, binding rules obliging credit registers to collect both positive and negative data and ensure full data disclosure would contribute to the provision of more complete information, thereby enabling mortgage lenders to fully assess the credit risk connected with a potential consumer and make a risk adequate product offer.

By obliging mortgage lenders to inform the consumer immediately, and without charge, of the result of the consultation of a credit register if the rejection of the credit application is based on the consultation of this credit register, the consumer would – if necessary – be able to correct any data which has been wrongly stored. This would contribute to the correctness of the information stored in credit registers. In addition, this would also ensure a consistent approach with the proposed Consumer Credit Directive.

The obligation for credit registers to provide consumers on a regular basis with a document on the information held on them would provide consumers with a chance to correct those data. This would increase the correctness of data held. Article 12 of the Data Protection Directive[152] already ensures that a consumer has the right to access to their personal data without constraint at reasonable intervals and without excessive delay or expense. However, invoking this right involves an own initiative from the consumer. A consumer might not necessarily be actively aware however that their personal data is held by the register and that this data might be wrong. By providing consumers with a regular statement containing their personal data, consumer's attention would be drawn to the data. Consumers should therefore be offered the chance to correct any wrong data. The requirement to send a regular document containing the data of a consumer would impose costs on credit registers. In case, that credit registers have to provide the document without any expense to the consumer, credit registers might increase their fees for mortgage lenders.

Customer mobility would also be enhanced. Mortgage lenders offering their products cross-border would be able to compete more effectively for new business. Provided that their credit histories are positive, consumers could benefit from the risk based pricing, and would be able to obtain better deals at better prices. In such circumstances, consumers would therefore have an incentive to switch providers.

This option would involve costs for Member States, which would need to transpose the directive into their national law. Credit registers would also face costs for possibly amending their access conditions. These could in turn be passed onto mortgage lenders in form of higher fees for obtaining credit information.

[152] Directive 95/46/EC, 24.10.1995.

Table 29: Impacts of Option 4

Option	Affected parties Direct impact (D) Indirect impact (I)	Impacts ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	Timing One-off Short-term Medium-term Long-term	Nature Dynamic Static	Likelihood Certain High Medium Low
Legislation	Consumers (I)	+ ↓ prices because more risk accurate (I) +/++ on the accuracy of consumer's personal data (I) + ↑ customer mobility (I)	Medium to long term	Dynamic	High
	Mortgage lenders (D)	+ ↓ information asymmetries (D) ++ non-discriminatory access of credit registers (D) +/++ more complete credit information (D)	Medium to long term	Dynamic	High
	Credit registers (D)s	– ↑ costs for changing their access conditions and data collection process (D) – ↑ costs for collecting accurate consumer information (D) ≈/+ potentially ↑ in revenues arising from more credit applications	Medium to long term	Dynamic and static	High
	Member States (D)	– ↑ costs for implementation of legislation (D)	Medium term	Static	Certain

4.7. Comparison of options

Options 2–4 would all contribute to ensuring access to credit registers for mortgage lenders, however only Option 4 could ensure complete non-discriminatory access to credit registers. Option 4 has therefore the most positive impact on mortgage lenders by creating a level playing field across Europe. Options 3–4 would also contribute more complete information for mortgage lenders. While the success of Option 3 would be dependent on the willingness and ability of credit registers to engage in a self-regulation process, Option 4 could ensure that all credit registers provide comparable information reporting thresholds, definitions and the scope of data are harmonised. Both options could ensure that consumers are informed regularly about their stored data and would encourage therefore corrections from consumers.

Option 3 could deliver its benefits relatively fast, while a decision for Option 4 would require some time because the legislative process would mean that any changes would not enter into effect for several years.

All options entail costs for credit registers in terms of implementing new access conditions and new processes for data collection. These costs will quite possibly be passed on to mortgage lenders as the users of credit register services, which could in turn be passed on to their consumers. However, these costs are likely to be outweighed by the benefits of a mortgage rate that correctly reflects the credit risk of a borrower. Furthermore, Option 4 imposes costs for Member States for the implementation of the directive.

In conclusion, both self-regulation and the adoption of binding legislation have the potential to bring the desired results in terms of ensuring access for mortgage lenders to credit registers and of encouraging the provision of more complete information. However, the key difference between Options 3 and 4 is that self-regulation in its purest form cannot completely ensure non-discriminatory access for mortgage lenders and the provision of more complete information whereas binding legislation can.

Table 30: Overview of policy option effectiveness

Option		Specific objective: Ensure non-discriminatory access to credit registers	Specific objective: Encourage the provision of more complete information	General objectives: Cross-border activity	General objectives: Product diversity	General objectives: Consumer confidence	General objectives: Consumer mobility	Comments
2	Enforcement of existing EU rules	≈/+	≈	≈/+	≈	≈	≈/+	
3	Self-regulation	+	+	+	≈	≈	≈/+	Effectiveness uncertain.
4	Legislation	++	+	+/++	≈	≈/+	+	

Assessment: ++ = strongly positive; + = positive; – – = strongly negative; – = negative; ≈ = neutral/marginal; ? = uncertain

5. PROPERTY VALUATION

5.1. Context

Property valuation can serve a variety of different roles. It can be used for accounting purposes, regulatory capital purposes[153], as well as for mortgage lending purposes. Property valuation may also be important for the consumer to ensure that he is paying the right price for a particular property. This section will focus on the role of property valuation in the mortgage lending process.

Property valuation is of vital importance for a mortgage lender for a variety of reasons relating to both primary and secondary markets. Valuation is a key element in the assessment of the risk of the mortgage loan and thus of the decision of the mortgage lender to offer the customer a loan. Although, through different circumstances, the income of the consumer may fluctuate, the mortgage lender can rely on the value of the property as a guarantee if the consumer would not be able to fulfil his obligations under the loan contract.

Property valuation is also important for obtaining secondary market funding. For covered bonds, consistent property valuation and loan-to-value ratios are one of the core eligibility criteria of mortgage assets being accepted as cover assets for covered bond funding. Loan-to-value ratios and consistent portfolio valuation are also an important aspect of mortgage securitisation and whole loan sales. Any rating of mortgage backed securities requires a valuation of the mortgage assets to be securitised. In the event of uncertainty surrounding the underlying value of the security, investors are likely to demand a risk premium or to

153 The preferential risk weight of mortgage loans under the Capital Requirements Directive requires consistent property valuation in order to define the part of the loan which is eligible to the preferential treatment.

decide against investing in the asset. In such cases, mortgage lenders would face either higher refinancing costs or, theoretically, for certain products, would be unable to get funding at all. Consequently, consumers would face higher interest rates on their mortgage credit and there is a chance that some would be unable to find the most appropriate product for their needs.

All mortgage lenders will therefore make their own valuation of the property prior to granting a mortgage credit.

In the European Union, there is a patchwork of rules governing property valuations and the valuers who make them.

In general, three different approaches may be identified for property valuation: legislative, self-regulatory, or neither.[154]

A legislative approach has been adopted in countries such as Austria, Germany, Lithuania, Poland, Spain, and the Slovak Republic. In some countries, such as Germany and Spain, national valuation standards are used. In other countries, principally in the new Member States, such as Lithuania and the Slovak Republic, the standards adopted are based on with international standards such as International Valuation Standards (IVS)[155] and European Valuation Standards (EVS)[156]. In many countries, such as Germany and Sweden, covered bond laws set out certain valuation requirements for properties to be included in the cover pool.

Self-regulation has been used in a variety of forms across the EU. In the UK, self-regulation in the field of property valuation is well developed. The standard setting body, the Royal Institution of Chartered Surveyors (RICS) has mechanisms to ensure quality standards. Standards in the Netherlands were determined by regulation until 2001 when the law was repealed. Currently, self-regulation is used. A number of sector associations and registers set certain quality standards which their members need to meet. In the Czech Republic, the Chamber of Appraisers develops valuations standards which are binding for their members. In Finland, the Property Valuation Association recommends that their members use IVS. In Belgium there are several valuers' federations which set their own codes and guidelines. Based on information provided to the Commission, these self-regulatory standards are, in general terms, in line with international standards (IVS/EVS).

In other countries, such as Greece and Italy, there are no detailed property valuation standards in place– be they either legislative or self-regulatory.

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154 All information on the situation in Member States is taken from contributions of Member States to the Government Expert Group on Mortgage Credit. See http://ec.europa.eu/internal_market/finservices-retail/home-loans/gegmc_comments_en.htm for further information.

155 The IVS are valuation standards developed and published by the International Valuation Standards Committee (IVSC). The IVSC was founded in 1981 by the valuation profession. The most recent edition of IVS was published in 2007.For more information see www.ivsc.org.

156 The EVS are valuation standards developed and published by the European Group of Valuers' Associations (TEGoVA). TEGoVA is a non profit making association composed of 40 valuers' associations from 27 countries. The most recent edition of EVS was published in 2003 and is available on the TEGoVA webpage – www.tegova.org. New EVS will be published in 2008.

At the EU level, the Capital Requirements Directive[157] provides a set of regulation for property valuation being carried out for lending purposes, covering definitions of values, certain assessment criteria, monitoring and revaluation requirements.[158] However, the regulated issues provide a framework only, leaving flexibility for Member States to determine property valuation in more detail, for instance by setting definitions other than the market value and the mortgage lending value or defining valuation methods. Furthermore, Council Directive 91/647/EEC of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings sets out specific Market Value definitions for property values.

The valuation profession is also subject to a variety of different conditions.[159]

In many countries, property valuation is not a regulated profession. Certification procedures exist, generally through professional bodies. Certification procedures commonly have both a theoretical and a practical part. For example, in Latvia, certification is done by the Valuers Certification Office of the Latvian Valuers Association that verifies professional knowledge and practical skills. In Ireland, there is no statutory regulation of valuers although most belong to professional bodies. Likewise, in the Netherlands and the UK, quality standards are industry led. In some cases, there are also requirements for ongoing professional training.

In some countries, there is a legal framework for valuers. In the Slovak Republic and Hungary, the profession is regulated. In Germany, valuation is not a specific profession; valuers are generally civil engineers or architects who have achieved the relevant professional qualifications which are defined in legislation.[160]

In general, there is some evidence of increasing formal certification of the valuation profession at the national level.[161]

At the EU level, the Capital Requirements Directive provides for certain requirements regarding the valuer, however, without specifying in detail what kind of qualifications are necessary.[162]

5.2. Problem description

Mortgage lenders operating cross-border face two main problems regarding property valuation. They need to be able to rely on the property valuation they receive and they must be able to use the valuation report they receive for a foreign property.

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157 The Capital Requirements Directive comprises of Directives 2006/48/EC, 14.6.2006 and 2006/49/EC, 14.6.2006.

158 Annex VIII, Part 2, point 8 and Part 3, 1.5.1 of Directive 2006/48/EC, 14.6.2006.

159 All information on the situation in Member States is taken from contributions of Member States to the Government Expert Group on Mortgage Credit. See http://ec.europa.eu/internal_market/finservices-retail/home-loans/gegmc_comments_en.htm for further information.

160 *The Valuation of Property for Lending Purposes*, European Mortgage Federation, 2005, p. 58.

161 Cf. footnote 160, p. 59.

162 Annex VIII, Part 2, point 8 of Directive 2006/48/EC, 14.6.2006.

5.2.1. Reliability of the valuation

A key concern of mortgage lenders is the reliability of any property valuation they receive. In a cross-border context, it is important that mortgage lenders can have full confidence in the valuation process and the qualification of the valuer. However, the confidence of the mortgage lender can be impaired by several factors: lack of common valuation principles (definitions of basic technical terms and reporting requirements); lack of common valuation methods; and lack of common standards for the professional qualification of property valuers in the different Member States.

First, regarding the valuation principles, it is important for a mortgage lender that the definitions used in valuation reports prepared according to national and foreign standards are coherent. If they differ, the valuation base would be different, leading to non-comparable results in terms of collateral values in the different countries or giving room to different interpretations. While the Capital Requirements Directive provides for definitions of the mortgage value and the mortgage lending value, which are apparently commonly used across Member States, it does not outline a comprehensive set of definitions commonly used in the valuation process such as the definitions for rental area, net or gross surface, construction and property management cost, etc. Therefore, national legislations or self-regulation can come up with their own definitions which may result in huge differences in the value of the collateral.

The same problem of varying or non-existing standards exists with regard to valuation reports. In general, a report must include a fair presentation of how the value has been determined, i.e. a description of the property, the basis of valuation and any special conditions or risks relating to the property, so that the mortgage lender can reconstruct how the valuer arrived at a certain value. Since not in all Member States impose reporting requirements, the reporting standards vary between Member States, therefore impairing the legibility and understandability of reports prepared from valuers in different jurisdictions.

Second, valuation methods also differ between Member States because they reflect historic developments.[163] Both the market value and the mortgage lending value can be determined by a range of different methods, for instance, the income method, the comparison method or the depreciated replacement cost method, leading inevitably to different valuation figures.[164] Any mortgage lender engaging in cross-border lending would therefore first have to enquire whether the market value or the mortgage lending value approach is used in the foreign country and second, what kind of valuation method has been used in order to get a picture of the value of the collateral.

Third, the level of training required of property valuers across Europe varies considerably with some Member States not regulating property valuers at all. This makes it hard for a potential mortgage lender to judge whether a valuer has the competence to deliver a valuation based on the standards sought by the mortgage lender. In addition, since valuation methods become increasingly sophisticated, it is indispensable that a valuer has sufficient skills to understand the methods used.

163 Cf. footnote 160, p. 56.
164 Cf. footnote 160, p. 6.

5.2.2. *Usability of the valuation report*

Several issues have been identified with respect to the acceptance of a valuation report by public authorities for a foreign property.

The valuation of a foreign property can be done in two ways: either the mortgage lender uses a valuer from his own country to do the valuation or he uses a valuer from the country where the property is located.

The use of a valuer from the mortgage lender's home country has the advantage that the valuer can produce a valuation report according to the valuation standards imposed by the mortgage lender's home country. However, the valuer might not be allowed to undertake a valuation in another country. For instance, it seems that, in Poland, only licensed appraisers, as designated by the authorities according to special legislation, may carry out valuations and only based on Polish valuation standards. This means that a foreign valuer has to get a Polish licence before he can undertake a valuation.[165] A mortgage lender might therefore face additional costs in offering mortgage credit in Poland, which increases the overall cost of engaging in cross-border business, with the cumulative effect of such costs preventing the mortgage lender from engaging in cross-border activity.

The mortgage lender might however opt for using a local valuer because only the local valuer might have the required knowledge of the foreign property market.[166] A problem arises in those countries, where a regulatory framework exists in the home country of the mortgage lender as well as in the country where the property is located and where the regulators in the country of the mortgage lender do not accept a valuation report prepared under the foreign framework or require additional information to adapt the foreign valuation report.[167] For instance, although German regulators accept data and estimates from a foreign report, additional information is required to fulfil the German requirements of the mortgage lending value.[168]

The mortgage lender is therefore faced with the requirement to comply with two different sets of valuation rules. The existence of different national regulations in the mortgage lender's home country as well as the country in which the property is based will therefore impose additional costs for the mortgage lender and deter cross-border activity.

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165 According to information provided to the Commission, German banks engaging in the Polish mortgage market use their own valuers which have acquired a Polish licence.

166 The use of local valuers in cross-border transactions becomes more important with the growing diversification by lenders. See footnote 160, p. 59.

167 No problem arises if the country of the lender has a regulatory valuation framework but not the country where the property is located or vice versa. In those cases, the valuation can be done according to the rules of either the home country of the lender (first case) or the country of the property (second case).

168 In the UK, valuation is based on the market value, while in Germany the mortgage lending value has to be determined. For the UK valuation, different to the German valuation requirements, the disclosure of a separate land value is not required.

Table 31: Problems and consequences

Problem	Consequences
Reliability and usability of the valuation report restricted for mortgage lenders ▪ different valuation principles (definitions and reporting requirements) in Member States ▪ different valuation methods in Member States ▪ different standards for the professional qualification of property valuers	For mortgage lenders: – Uncertainty regarding the quality and reliability of the valuation report =>uncertainty regarding the true value of the collateral. – Uncertainty regarding the acceptance of the report by public authorities – Compliance with two sets of valuation rules =>higher costs, for instance for funding => reduced scope for economies of scale => Mortgage lenders may be deterred from cross-border activity on primary and/or secondary markets => Reduced competition For investors: – Uncertainty regarding the value of underlying security => reduced demand or higher premium For consumers: – higher prices – reduced product diversity

5.3. Stakeholder's views

5.3.1. Consumers

All consumers answering to the consultation on the Green Paper on Mortgage Credit were in favour of developing a single EU standard for valuation. They also agree that there should be mutual recognition of valuation standards and supported the development of a single EU standard for valuers' qualifications.[169]

5.3.2. Mortgage lenders

The majority of mortgage lenders support in principle the introduction of a single EU standard for valuation because such standard would create a level playing field between lenders in different jurisdictions.[170] Some mortgage lenders are of the opinion that convergence in valuation principles and professional requirements could be achieved through a Recommendation rather than through binding EU regulation.[171] Mortgage lenders argue

169 Cf. footnote 35, pp. 36–38.
170 Cf. footnote 35, pp. 36–38.
171 See *Report of the Mortgage Funding Expert Group*, 22.12.2006, p. 17, http://ec.europa.eu/internal_market/finservices-retail/home-loans/integration_en.htm#mfeg.

however that a degree of differentiation might be required in order to take into account local characteristics. The majority of mortgage lenders also support the mutual recognition of valuation standards and the introduction of a single EU standard for valuers.

5.3.3. Member States

Member States are mixed in their views as to whether there should be a single EU standard for valuation and valuers' qualifications. A small majority are however in favour of developing such standards.[172] The majority of Member States is opposed to the mutual recognition of valuation standards.

5.4. Objectives

In general terms, the Commission seeks to remove the economic and legal barriers to the cross-border supply of mortgage credit. Specifically, in terms of property valuation, the Commission aims to:

- remove the obstacles to the use of foreign valuation reports; and
- promote the development and use of reliable valuation standards

5.5. Description of options

5.5.1. Option 1: Do nothing

Mortgage lenders operating cross-border would continue to face problems with regard to the reliability of any property valuation and with regard to the usability of a valuation report for a foreign property. However, standard setting bodies such as the International Valuation Standards Committee and the European Group of Valuers' Associations have already developed and published valuation standards which are taken into account by mortgage lenders in some Member States without a legislative or self-regulatory framework on valuations, such as in the Czech Republic, Finland or Belgium.

5.5.2. Option 2: Self-regulation

The issue of different valuation standards across the EU could be dealt with by market practitioners by means of self-regulation. Market practitioners could be encouraged to develop valuation standards including definitions, reporting requirements, valuation methods and professional qualifications of property valuers. Industry could adopt a Code of Conduct to ensure the application of the developed valuation standards across Europe.

As described above, similar market based initiatives, such as those led by the International Valuation Standards Committee and the European Group of Valuers' Associations, have already been undertaken.

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172 Cf. footnote 35, pp. 36–38, and comments provided by members of the Government Expert Group on Mortgage Credit: http://ec.europa.eu/internal_market/finservices-retail/home-loans/gegmc_comments_en.htm.

5.5.3. Option 3: Recommendation

A recommendation could invite Member States to align mortgage lending valuation practices with the Capital Requirements Directive framework. Furthermore, in this recommendation, Member States could be invited to ensure that valuers are properly qualified and to ensure mortgage lenders do not face unnecessary costs when using a foreign valuation report.

5.5.4. Option 4: Legislation (mutual recognition of valuation standards)

The Commission could consider obliging Member States to mutually recognise national valuation standards for mortgage lending purposes within the EU.

The mutual recognition of valuation standards for mortgage lending purposes, which has been suggested by some stakeholders, does not help to address the issues identified for valuation. For mutual recognition to be a viable option for the removal of obstacles to the use of foreign valuation reports, minimum standards would have to be ensured. Since those minimum standards are not yet in place, it cannot be excluded that mutual recognition would have a detrimental effect on the quality of valuation reports at least in some Member States. In addition, mortgage lenders and investors would be in the same situation as they are today because they would not have the confidence that the property valuation they receive reflects a fair value of the mortgaged property. This option can therefore be ruled out already at this stage.

5.5.5. Option 5: Legislation (harmonisation)

The Commission could consider the harmonisation of valuation standards for mortgage lending purposes, including definitions, reporting requirements, valuation methods and professional qualifications of property valuers.

5.6. Impact assessment

5.6.1. Option 1: Do nothing

The work currently undertaken by the different valuation standard setting bodies could in principle help to develop reliable valuation standards. While it is unlikely that there will be convergence to one single valuation standard in Europe because at least three different valuation standard setting bodies exist in Europe (the International Valuation Standards Committee, the European Group of Valuers' Associations and the Royal Institution of Chartered Surveyors), which are used to a varied extent by mortgage lenders in different Member States, all of these bodies provide for reliable valuation standards. However, not all of these international valuation standards include mandatory rules for the professional qualifications of a valuer. So even if the international valuation standards increase the reliability of the valuation report to a certain extent, mortgage lenders cannot be fully confident that the valuation report has been prepared by a valuer with the necessary qualifications and expertise.

In addition, different national legislation would continue to exist. Consequently, the issue of usability of a valuation report on a foreign property which has been prepared under a different legislative framework or under international valuations standards remains. Those reports would have to be adapted to national requirements, therefore imposing additional costs on mortgage lenders.

This option would impose no costs for Member States.

Table 32: Impacts of Option 1

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Do nothing	Consumers	≈ prices (I) ≈ product diversity (I)	Medium to long term	Dynamic	Medium
	Mortgage lenders (D)	≈/+ confidence in valuation report they receive (D) ≈ use of valuation reports (D)	Medium to long term	Dynamic	Medium
	Investors (I)	≈/+ more certainty with regard to the value for mortgage backed investment products (I)	Medium to long term	Dynamic	Medium
	Member States	≈	n.a.	n.a.	Medium

5.6.2. Option 2: Self-regulation

Self-regulation could in principle ensure that mortgage lenders can rely on property valuation which is prepared in accordance with the valuation standards developed by market practitioners and that investors face more certainty with regard to the real value of their investments. Market practitioners including the different valuation standard setting bodies could attempt to develop one meaningful European valuation standard including definitions, reporting requirements, valuation methods and professional qualifications of property valuers, taking into account the local specificities of markets when necessary. Since valuation standards would represent best practices for valuation procedures, Member States with valuation legislation in place could compare their legislation with the best practices and, based on the comparison, could consider changes to their legislation.

However, self-regulation could not alter the current situation whereby mortgage lenders in those Member States, where the national legislation foresees national valuation standards, face additional costs for the adaptation of valuation reports prepared under a foreign legal framework or the valuation principles developed under self-regulation.

Only if Member States chose to adapt their legislation to valuation standards developed by self-regulation, would they face costs for the implementation of those changes.

Table 33: Impacts of Option 2

Option	Affected parties Direct impact (D) Indirect impact (I)	Impacts ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	Timing One-off Short-term Medium-term Long-term	Nature Dynamic Static	Likelihood Certain High Medium Low
Self-regulation	Consumers (I)	≈/+ ↓ prices (I) ≈/+ ↑ product diversity (I)	Medium to long term	Dynamic	Medium
	Mortgage lenders (D)	≈/+ confidence in valuation report they receive (D) ≈ use of valuation reports (D) –/≈ ↑ cost for changing valuation procedures (D)	Medium to long term	Dynamic	Medium
	Investors (I)	≈/+ ↑certainty with regard to the value for mortgage backed investment products (I)	Medium to long term	Dynamic	Medium
	Valuers (D)	–/≈ ↑ cost for complying with valuers' qualifications requirements (D)	Medium to long term	Dynamic	Medium
	Member States (I)	–/≈ ↑ depending on whether Member States decide to amend their legislation in line with the self-regulatory standards (I)	Medium to long term	Static	Medium

5.6.3. *Option 3: Recommendation*

Promoting the endorsement of the definitions on the market value and the mortgage lending value as defined in the Capital Requirements Directive for property valuation undertaken in the process of mortgage lending would clearly inform the mortgage lender on what value a valuation report has been based and therefore increase confidence of the mortgage lender with respect to the property valuation he receives. However, a common definition for these two values alone would not lead to fully comparable results on terms of collateral values as there are other definitions commonly used in the valuation process, such as the definitions for rental area, net or gross surface, etc.

The invitation to encourage mortgage lending on the basis of international valuation standards including adherence to standards on reporting requirements could ensure the convergence to minimum valuation standards across Europe. Mortgage lenders and investors would benefit because they would be able to rely on the property valuation they receive, regardless whether the property valuation is done on the national level or in a cross-border context. If Member States with existent legislation on property valuation would change their framework according to the international valuation standards, the adaptation of reports prepared under a foreign framework to national requirements would not be necessary. However, even if Member States do not choose to bring their framework in line with international valuation standards, they could however foresee possibilities of recognising other national valuation standards to ensure that mortgage lenders do not face unnecessary costs when using a foreign valuation report.

The recommendation to ensure that valuers are properly qualified would also increase the reliability of valuation reports which benefits mortgage lenders and investors because they can be more confident that the valuation report has been prepared with the necessary knowledge.

This option imposes costs on Member States for the introduction of valuation standards or for changes to existing legislation on valuation standards if Member States chose to act accordingly to the recommendation. Costs could also arise for mortgage lenders which would have to adapt their current valuation standards to new legislation. Valuers would also face costs in adapting their professional qualifications to the valuers' qualifications imposed or recommended by Member States.

Table 34: Impacts of Option 3

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Recommendation	Consumers	≈/+ ↓ prices (I) ≈/+ ↑ product diversity (I)	Medium to long term	Dynamic	Medium (dependent on action undertaken by Member States)
	Mortgage lenders (D)	≈/+ confidence in valuation report they receive (D) ≈/+ use of valuation reports (D) –/≈ ↑ cost for changing valuation procedures (D)	Medium to long term	Dynamic	Medium (dependent on action undertaken by Member States)
	Investors (I)	+ more certainty with regard to the value for mortgage backed investment products (I)	Medium to long term	Dynamic	Medium (dependent on action undertaken by Member States)
	Valuers (D)	–/≈ ↑ cost for complying with valuers' qualifications requirements (D)	Medium to long term	Dynamic	Medium (dependent on action undertaken by Member States)
	Member States (D)	– –/– ↑ cost for implementing legislation (D)	Medium to long term	Static	Medium (dependent on action undertaken by Member States)

5.6.4. Option 5: Legislation (harmonisation)

Harmonisation of valuations standards across Europe would benefit mortgage lenders and investors alike. Valuation standards for mortgage lending purposes could either be fully harmonised or the setting of minimum valuation standards, eventually combined with mutual recognition, could be considered.

On the one hand, fully harmonised valuation standards would have the benefit that mortgage lenders could have full confidence in the reliability of any property valuation they receive, regardless whether it is done on a national level or in a cross-border context. Fully harmonised valuation standards would also create a level playing field between mortgage lenders in different Member States. Valuation reports would not have to be adapted anymore. Uncertainty for investors in capital market products which are backed by mortgage loans would be reduced with regard to the value of the mortgage property.

On the other hand, it might not even be possible to introduce full harmonisation on valuation standards because national, regional or local specificities would need to be reflected in the valuation methods. In addition, a European fully harmonised valuation standard, which is lower than national valuation standards currently in place, could also have a detrimental impact on those national refinancing instruments for which the strict national valuation standard is an essential safeguard that is recognised by investors. For instance, the German Pfandbrief Act imposes strict valuation rules for the mortgage loans to be included in the cover pool. Investors enjoy therefore the security that their claims will be safeguarded by a sufficient value of property. Without this guarantee, investors would demand a higher premium, thereby increasing the refinancing costs for the mortgage lender, and potentially increasing the costs of taking out a mortgage credit for consumers.

Minimum valuation standards could ensure that mortgage lenders receive a valuation report which gives them confidence that the estimated value of the property can be relied on. Investors would in principle also benefit with higher certainty regarding the value of their investment. However, with the establishment of binding minimum standards, Member States would be allowed to go beyond these minimum standards. If Member States choose to impose additional stricter valuation standards, mortgage lenders would have to adapt valuation reports which have been prepared under a different national framework to their national standards. The situation that mortgage lenders would face additional costs for the usability of a valuation report on a foreign property prepared under a different national framework would therefore not change. This could only be avoided if minimum valuation standards would be combined with mutual recognition of national valuation standards. However, as described above, this might have a detrimental effect on some refinancing instruments for which strict national valuation standards are an essential safeguard recognised by investors.

A harmonisation of valuation standards, either fully harmonised or imposing minimum requirements, across Europe would involve considerable efforts in terms of time and cost to establish those standards.

In addition, the introduction of a European harmonised framework on valuation would entail costs for certain stakeholders. Member States, which have already legislation on valuation standards for the mortgage lending process in place, would have to reconcile their national systems with the new legislation. The scope and extent of the required changes would depend largely on the valuation standards set in a Directive and their compatibility with the national law. Member States without any legislation on valuation in place would also face costs for the introduction of a valuation framework. Mortgage lenders would also face some costs for adapting their internal valuation procedures to the new rules including possible training for in-house valuers. Valuers would probably also face costs in adapting their professional qualifications to the valuers' qualifications imposed by the Directive.

Table 35: Impacts of Option 5

Option	Affected parties Direct impact (D) Indirect impact (I)	Impacts ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	Timing One-off Short-term Medium-term Long-term	Nature Dynamic Static	Likelihood Certain High Medium Low
Legislation	Consumers	≈/+ ↓ prices (I) ≈/+ ↑ product diversity (I)	Medium to long term	Dynamic	Certain
	Mortgage lenders (D+I)	+/++ confidence in valuation report they receive (D) ≈/+ use of valuation reports (depending on full or minimum harmonisation) (D) – possibly higher funding costs for some mortgage lenders (depending on the chosen valuation requirements) (I) – ↑ cost for changing valuation procedures (D)	Medium to long term	Dynamic	High
	Investors (I)	? over all impact uncertain because depending on the chosen valuation requirements: => + ↑ certainty with regard to the value for certain mortgage backed investment products (I) => – ↓ safety for those mortgage backed investment products for which currently are strict valuation standards in place (I)	Medium to long term	Dynamic	High
	Valuers (D)	–/≈ ↑ cost for complying with valuers' qualifications requirements (D)	Medium to long term	Dynamic	Certain
	Member States (D)	–/– – ↑ cost for implementing legislation (D)	Medium to long term	Static	Certain

5.7. Comparison of options

Options 3 and 5 are the only options that have the potential to achieve both objectives of the Commission with respect to valuations. Options 1 and 2 would only have the potential to lead to a positive impact on the development and use of reliable valuation standards but would not impact on the second specific objective to ensure that mortgage lenders do not face any unnecessary costs when using a foreign valuation report.

However, since Option 3 is of a non-binding nature, it is unclear, to what extent Member States would follow the recommendations. Option 5 will through its binding nature ensure that Member States have to introduce at least minimum valuation standards.

In terms of costs, both Options 3 and 5 would impose costs for Member States for changing or introducing valuation legislation. In addition, any adoption of legislation would have to pass the legislative process and might therefore take a long time until it can be implemented by

Member States. The effort in terms of cost and time necessary for Option 5 seems however be disproportionate to the problem. The market seems to be moving towards the development and application of international valuation standards. Moreover, regulatory developments such as the Capital Requirements Directive are also promoting convergence. Especially in the new Member States, those valuation standards are either transposed into national valuation laws or used by means of self-regulation. Against this background, Option 5 would in the first place be useful to address the problem of the usability of valuation reports on foreign property which needs to be adapted to national legislation. However, as described above, this might not even be achieved if the outcome of the co-decision process would be minimum harmonisation on valuation standards. In addition, while it has to be acknowledged that some mortgage lenders do face some costs for adapting the valuation reports to national requirements, it seems to be doubtful whether these costs justify the introduction of legislation.

In conclusion, while Options 3 and 5 both have the potential to remove the obstacles to the use of foreign valuation reports and to promote the development and use of reliable valuation standards, Option 5 appears to be disproportionate to the scope of the problems given the ongoing movement of the markets towards the application of international valuation standards. Option 3 appears therefore to be the appropriate option moving forward. The Commission would however monitor closely if Member States follow the recommendations of the Commission. Should Option 3 prove ineffective in the long-run, the Commission could consider Option 5.

Table 36: Overview of policy option effectiveness

Options		**Specific objective**		**General objectives**				**Comments**
		Remove the obstacles to the use of foreign valuation reports	Promote the development and use of reliable valuation standards	**Cross-border activity**	**Product diversity**	**Consumer confidence**	**Consumer mobility**	
1	Do nothing	≈	≈/+	≈/+	≈	≈	≈	Work currently undertaken by the different valuation standard setting bodies.
2	Self-regulation	≈	≈/+	≈/+	≈	≈	≈	
3	Recommendation	≈/+	≈/+	+	≈	≈	≈	Effectiveness uncertain. Dependent on implementation by Member States.
4	Legislation	≈/+	+	≈/+	≈	≈	≈	Possible negative impact on investors and high implementation costs.

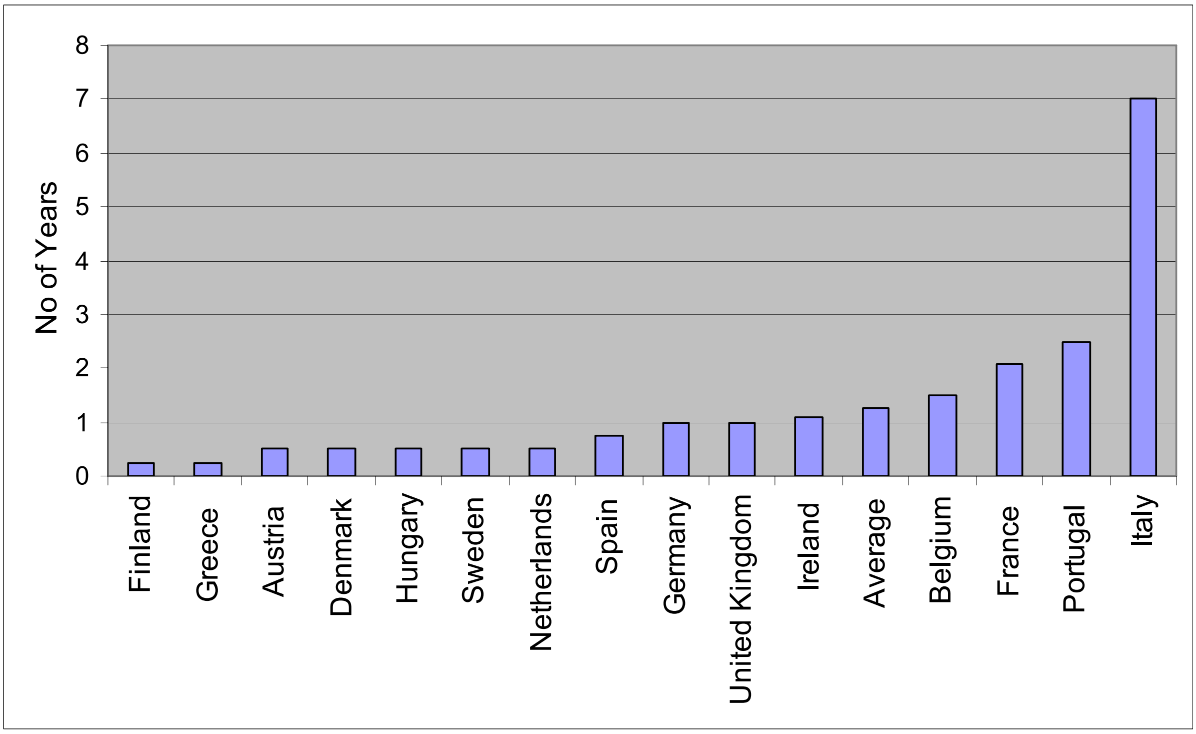
Assessment: ++ = strongly positive; + = positive; – – = strongly negative; – = negative; ≈ = neutral/marginal

6. FORCED SALES PROCEDURES

6.1. Context

The security constituted by the collateral (i.e. the property) is a central aspect of mortgage credit transactions. In the event that the mortgage borrower fails to meet the conditions set out in the mortgage loan contract, the mortgage lender can declare the entire debt due and launch legal proceedings to foreclose the property and thus satisfy the debt. Given the implications of losing a house, forced sales procedures are closely related to housing and social policies. In some European countries, for example, differences exist between the procedures applicable for first and second residences.

Graph 11: Usual duration of forced sales procedures (number of years)



Source: Based on data from European Banking Industry Committee, Final Report of the Mortgage Funding Expert Group, December 2006. **Note:** Where a range of figures is provided, for the purpose of this graph, the maximum is taken.

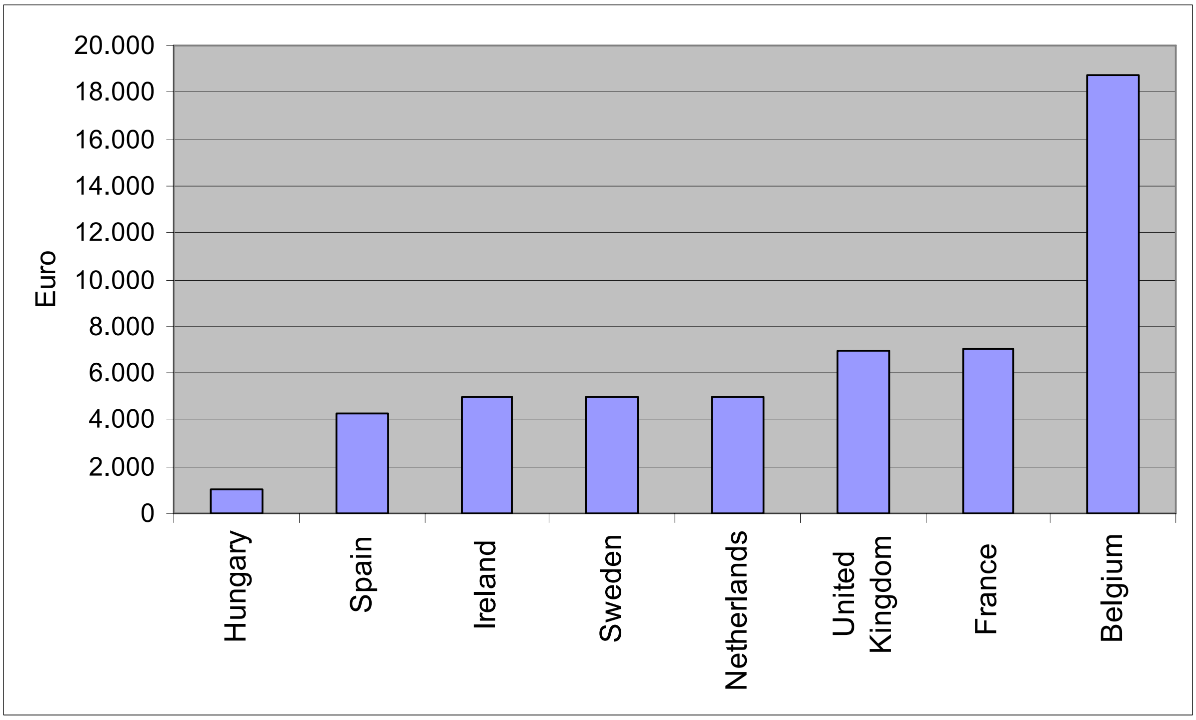
Forced sales procedures vary widely in duration and cost throughout the EU. Forced sales procedures can generally be divided into three stages: court proceedings, sales proceedings and the time taken for payment of creditors. Although the average duration for the whole process is 6 to 12 months, the process can range from two months in Finland to up to seven years in Italy[173]

The duration of forced sale procedures varies due to several factors including judicial systems, litigation traditions and length of legal deadlines.

[173] Cf. footnote 171, p. 22.

The total costs for a forced sale procedure can vary from three per cent to nineteen percent of the outstanding loan balance.[174]

Graph 12: Average cost of forced sales procedures for a EUR 100 000 loan balance



Source: Based on data from European Banking Industry Committee, Final Report of the Mortgage Funding Expert Group, December 2006. **Note:** Where a range of figures is provided, for the purpose of this graph, the maximum is taken.

6.2. Problem description

Although enforcement of the mortgage collateral is the worst-case scenario and a wide range of alternative measures exists through which a mortgage lender can help the borrower to avoid the sale of the property, it is also important for the mortgage lender to be able to foreclose the loan and call upon the security through a forced sale of the mortgaged property. Excessively long and costly forced sale procedures create several problems for mortgage lenders in this respect.

Inconsistent and lengthy foreclosure periods are in general for all lenders a source of uncertainty as to when and to what extent the recovery of any money from a defaulted borrower is feasible. This uncertainty is ultimately translated into higher cost of borrowing for the consumer.[175] Moreover, the legal difficulties associated with foreclosing a loan as well as the costs associated with it can deter new entrants to the mortgage credit market.[176]

The difficulties faced by mortgage lenders in the cost and duration of foreclosure procedures also translate into higher costs of financing on capital markets by creating uncertainty for investors in the capital market products backed by the mortgages. This fact can also deter the creation of cross-border pools of mortgage backed assets as those securities backed by

174 Cf. footnote 171, p. 22.
175 Cf. footnote 171, p. 21.
176 Cf. footnote 171, p. 21.

mortgages from countries deemed to have less efficient foreclosure procedures and thus a higher risk would increase the risk of the overall pool thereby reducing the economic incentive to pool.[177] The higher costs of financing mortgages on secondary markets may then be passed onto consumers in the form of higher interest rates.

Excessively long or expensive foreclosure procedures therefore raise the costs for consumers in general and hinder the development of cross-border activity on both primary and secondary markets by disproportionately increasing the costs for cross-border activity, therefore ultimately limiting consumer choice.

Table 37: Problems and consequences

Problem	Consequences
Excessively long and expensive forced sales procedures ▪ Different legal frameworks for forced sales ▪ Different judicial frameworks	For mortgage lenders: – Higher financing costs for mortgage lenders on secondary markets due to the uncertainty with regard to recovery of any debt from a defaulted borrower => reduced scope for economies of scale => Mortgage lenders may be deterred from cross-border activity => Reduced competition For consumers: – Limited product choice – Higher prices For investors: – Uncertainty with regard to recovery of any debt from a defaulted borrower => Reduced demand

6.3. Stakeholder's views

6.3.1. Consumers

The majority of consumers support the idea of collecting information on the cost and duration of forced sales procedures in all Member States and presenting it in a regularly updated scoreboard in order to enhance the effectiveness of national forced sales procedures.[178]

6.3.2. Mortgage lenders

The majority of mortgage lenders are in favour of collecting information on national foreclosures procedures and publishing it in a scoreboard.[179]

177 Cf. footnote 171, p. 21.
178 Cf. footnote 35, p. 40.

6.3.3. Member States

Member States are also in principle in favour of establishing a scoreboard on the duration and cost of forced sales procedures. Some, however, questioned whether there was a real market failure in this area and whether forced sales procedures were really a barrier to integration.[180]

6.4. Objectives

The Commission seeks to remove the legal and economic barriers to the cross-border provision of mortgage credit. To this end, it wishes to encourage a reduction in the average duration and cost of forced sales procedures with regard to the mortgaged property.

6.5. Description of options

6.5.1. Option 1: Do nothing

Doing nothing would mean that all the problems identified remain: mortgage lenders would remain uncertain as to when and to what extent the recovery of any money from a defaulted borrower is feasible. The Commission has already noted the difficulties of cross-border debt recovery in its 1998 Communication 'Towards greater efficiency in obtaining and enforcing judgments in the European Union'[181]. The differences in the efficiency of debt-recovery within the European Union have been identified as risking distorting competition among businesses.[182] The Commission is already taking measures to address this issue. However, due to the diversity of Member States' legislation and the complexity of the subject, the Commission has decided to confine reflection on this issue initially to the problem of banking seizures.[183]

6.5.2. Option 2: Scoreboard

The Commission could collect information on the cost and duration of foreclosure procedures in all Member States and present it in a regularly updated 'scoreboard'. This 'scoreboard' could be made public in order to enable mortgage lenders and investors to assess some of the risks connected with foreclosure procedures in other Member States and to impose a certain peer pressure on Member States with lengthy and expensive foreclosure procedures.

6.5.3. Option 3: Recommendation

The Commission could invite Member States to review their foreclosure procedures to ensure that foreclosure procedures are completed within a reasonable time limit and under reasonable cost. It could also be recommended that Member States seek to ensure that the maximum duration of foreclosure proceedings is capped.

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179 Cf. footnotes 35, p. 40 and 171, p. 21.

180 Cf. footnote 35, p. 40, and comments provided by members of the Government Expert Group on Mortgage Credit: http://ec.europa.eu/internal_market/finservices-retail/home-loans/gegmc_comments_en.htm.

181 Commission Communication (98 C 33/03), 31.1.1998, p. 3.

182 *Green Paper on improving the efficiency of the enforcement of judgments in the European Union: The attachment of bank accounts*, SEC(2006) 1341, 24.10.2006, p. 3.

183 Cf. footnote 182, p 3.

6.5.4. Option 4: Legislation

An optimal model for forced sales procedures could be developed. This could then be introduced through binding legislation in order to improve the efficiency of foreclosure proceedings in the different Member States. Such an approach could in principle help to improve the efficiency of foreclosure proceedings in the different Member States. However, as stated above, such an approach would involve considerable difficulties because of the diversity of Member States' legislation and the complexity of the subject. Before any such approach could be considered, further detailed comparative analysis of the different national frameworks on forced sales procedures would be required in order to explore the possibility and feasibility of their improvement at Community level.

6.6. Impact assessment

6.6.1. Option 1: Do nothing

The work currently undertaken by the Commission with the view to examine the necessity of community action on enforcement could potentially meet the objective of the Commission to reduce the average duration and cost of forced sales procedures with regard to mortgaged property if the reflection of the Commission will be extended in the future to this issue and relevant measures are considered.. Any impact on stakeholders will be dependent on the measures taken and can therefore not be assessed at this point in time.

6.6.2. Option 2: Scoreboard

The publication of a scoreboard would have several consequences.

On the one hand, a 'scoreboard' could increase transparency for mortgage lenders in connection with the length and the costs of foreclosure procedures in the different Member States. Mortgage lenders could take this information into account when offering their products in other Member States and adjust their pricing accordingly. Investors could also use this information to decide whether and to which price to invest in mortgage funding products from different Member States. Consumers would benefit potentially from lower prices for their mortgage loans due to higher competition on their national markets. The increased transparency for mortgage lenders and investors could also have the effect that mortgage lenders and investors might choose not to offer their products or to invest in those Member States which have lengthy and expensive foreclosure procedures. Should the latter be the case, there would be no effects for consumers from the scoreboard.

On the other hand, a scoreboard is an information tool only and it cannot solve the problem of the existing variety of forced sales procedures as such. The scoreboard might however impose a certain peer pressure on Member States with lengthy and expensive foreclosure procedures because the scoreboard clearly sets out in which countries mortgage lenders face the highest uncertainty to recover their loans. As a result, those Member States might take action to increase the efficiency of their national foreclosure procedures and converge towards best practice.

The compilation of a scoreboard would impose costs on Member States who would be required to collect and provide the necessary data to the Commission.

Table 38: Impacts of Option 2

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Scoreboard	Consumers (I)	+ ↑ product diversity (I) + ↓ prices (I)	Long term	Dynamic	Medium
	Mortgage lenders (D)	+ ↑ information on efficiency of national foreclosure proceedings (D) ≈ certainty as to recovery of money because existence of different national foreclosure proceedings with varying degrees of efficiency (D)	Medium to long term	Dynamic	Medium
	Investors (D)	+ ↑ information on efficiency of national foreclosure proceedings (D) ≈ certainty as to recovery of money because existence of different national foreclosure proceedings with varying degrees of efficiency (D)	Medium to long term	Dynamic	Medium
	Member States (D)	– ↑ Cost for compiling data and improvement of national foreclosure procedures (D)	Medium to long term	Dynamic	Certain

6.6.3. Option 3: Recommendation

A recommendation to Member States could in general reduce the average duration and the average costs of forced sales procedures, provided that Member States reviewed their foreclosure procedures with the view to making them more efficient in terms of time and cost requirements. Mortgage lenders and investors would profit from more certainty as to their prospects of recovering debts. Consumers would in turn profit from lower prices and higher product diversity. Member States would incur administrative costs in terms of time and resources in making their foreclosure procedures more efficient.

The recommendation of a target maximum duration of foreclosure proceedings could further improve certainty for mortgage lenders and investors and bring the described indirect benefits to consumers. However, before being able setting such a maximum duration target, which is feasible, the Commission would have to determine such a figure based on the foreclosure practices in the different Member States and based on a clear definition as to which proceedings are considered to form the foreclosure process.

Table 39: Impacts of Option 3

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Recommendation	Consumers (I)	+ ↑ product diversity (I) + ↓ prices (I)	Long term	Dynamic	Medium (depends on whether Member States choose to act)
	Mortgage lenders (D)	+ ↑ certainty as to recovery of money through increasing efficiency of different national foreclosure proceedings (D)	Medium term	Dynamic	Medium (depends on whether Member States choose to act)
	Investors (D)	+ ↑ certainty as to recovery of money through increasing efficiency of different national foreclosure proceedings (D)	Medium term	Dynamic	Medium (depends on whether Member States choose to act)
	Member States (D)	– ↑ cost for improvement of national foreclosure procedures (D)	Medium term	Dynamic	Medium (depends on whether Member States choose to act)

6.7. Comparison of options

To what extent Option 2 would fulfil the objective of the Commission to encourage a reduction in the average duration and cost of forced sales procedures is heavily dependent on whether Member States with long and costly forced sales procedures react to the peer pressure introduced by a scoreboard which is published on a regular basis. Any changes to forced sales procedures to increase effectiveness cannot be enforced. This also holds true for Option 3. Option 2 however has the advantage of being able to inform mortgage lenders and investors about the average duration and cost of foreclosure proceedings across Europe and therefore limit – at least to some extent – the uncertainty as to when and with which costs the recovery of any debt from a defaulted borrower is feasible.

Option 2 would take time to be effective in terms of Member States improving the efficiency of their forced sales procedures. However, a necessary intermediate step would be the definition of the elements of the scoreboard in close cooperation with Member States to understand and respect national specificities in order to give objective information on the duration and cost of forced sales procedures. The establishment of the scoreboard could be undertaken relatively quickly, thus providing information on the different national foreclosure procedures to mortgage lenders and investors. Option 3 would however also require time before taking effect. Before a realistic maximum target duration could be recommended, the Commission would first have to establish the scoreboard in order to get more information about the various national systems in place.

In terms of cost, both options would involve costs for those Member States which choose to change their foreclosure proceedings in order to make them more efficient and for all Member States for the compilation of data.

In conclusion, Option 2 appears to be the preferred option because it would on the one hand provide relatively quickly information on national foreclosure procedures to mortgage lenders and investors and on the other hand would enable the collection of the necessary information to potentially enable the establishment of a maximum target duration for Option 3. However, it would, under Option 2, take time for any changes in the duration and costs of national foreclosure procedures to become effective as they are based on the peer pressure imposed through a regularly updated scoreboard. Option 2 should therefore be continually monitored in terms of effectiveness. Should Option 2 prove ineffective, the Commission could consider other measures.

Table 40: Overview of policy option effectiveness

Option		Specific objective	General objectives				Comments
		Encourage a reduction in the average duration and cost of forced sales procedures	**Cross-border activity**	**Product diversity**	**Consumer confidence**	**Consumer mobility**	
1	Do nothing	≈	≈	≈	≈	≈	No changes in the short run.
2	Scoreboard	≈/+	≈/+	≈	≈	≈	Effectiveness dependent on reaction of Member States to peer pressure.
3	Recommendation	≈/+	≈/+	≈	≈	≈	Effectiveness uncertain because of non-binding character.

Assessment: ++ = strongly positive; + = positive; – – = strongly negative; – = negative; ≈ = neutral/marginal

7. LAND REGISTERS

7.1. Context

For the purposes of this analysis, collateral means any charge on property created by the legal owner in relation to the estate for the payment of a definite sum of money. It enables the mortgage lender in case of non-payment of the debt to levy the execution upon the real property by taking possession of the property and to receive rents and profits thereof; and/or a right of forced sale and receiving the proceeds from such forced sale.

Different types of mortgage collateral are used across Member States to secure mortgage loans, reflecting the diversity of legal systems and offering a different degree of flexibility in terms of transferability.[184] According to the nature of the mortgage collateral, different procedures to establish them are required. While some collateral is capable of being registered on request but may still be valid even if not registered (declaratory registration),[185] others become effective only upon registration in a public register (constitutive registration).[186]

7.1.1. Cross-border access

Before accepting a property as collateral for a loan, a mortgage lender has to be able to access the national land register in order to verify whether any other charges already exist, thereby granting rights to other third parties. National land registers and their accessibility differ in several ways. First, centralised registers do not exist in all Member States. For instance, Belgium, Denmark, Germany, Greece, Spain, France, Italy and Portugal do not have centralised register.[187] Furthermore, not all Member States have electronic registers and, consequently, not all land registers can be accessed on-line. For instance, there is no electronic register in France, while the registers in Germany and Greece are partly electronic depending on who is in charge of the register.[188] The (partly) electronic registers, for instance, in Denmark, Greece and Spain cannot be accessed on-line.[189] Regarding cross-border access to national land registers, in most Member States foreign mortgage lenders have the same access rights as national mortgage lenders. In some Member States, however, cross-border access is not possible or impaired compared to national mortgage lenders accessing the register for various reasons. In Hungary, for instance, the on-line register is not accessible cross-border. In Latvia; it is legally possible for foreign mortgage lenders to access the register on-line but in practice, access is limited because foreign mortgage lenders need a special permission from the State Land Service to get through the firewall.[190] In some Member States, such as Austria, Portugal, the Netherlands and the UK, it is already possible for foreign mortgage lenders to access the register on-line on a cross-border basis.

The issue of accessibility of land registers has already been recognised by the Commission when it provided funding to the EULIS project under the eContent programme (2001–2004) and the eTEN programme (2006–2007). EULIS is a service that aims to provide easy cross-border access to information about ownership and interests in land and property via the Internet. EULIS provides information on register contents, conditions for information usage and the national legal frameworks which enables users to understand the outputs they receive. The target customer group is a wide range of users including professional users in the real

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184 'Die grundpfandrechtliche Sicherung grenzüberschreitender Immobilienfinanzierungen', O. Stöcker, *Wertpapiermitteilungen*, 2006, p. 1933 (1945).

185 For instance, in Poland the principle of declaratory registration is predominant. Any change in the legal situation is not effected by registration. See *Flexibilität der Grundpfandrechte in Europa*, O. Stöcker, Vol. 1, 2006, p 275.

186 This is, for instance, the predominant principle in Germany, Austria and Hungary. See *Flexibilität der Grundpfandrechte in Europa*, O. Stöcker, Vol. 1, 2006.

187 *Study on Efficiency of the Mortgage Collateral in the European Union*, European Mortgage Federation, 2007, p 9. Comments provided by members of the Government Expert Group on Mortgage Credit: http://ec.europa.eu/internal_market/finservices-retail/home-loans/gegmc_comments_en.htm.

188 Cf. footnote 187, p. 9.

189 Cf. footnote 187, p. 9.

190 This problem is currently being addressed.

estate sector as well as the general public. EULIS currently has 10 participants[191] of which six land information services are accessible online through a single internet based portal.[192]

The Commission is currently preparing a Green Paper on the transparency of the debtor's assets, which is scheduled for adoption by the end of 2007. The scope of this Green Paper covers access to any kind of national registers, including land registers, by both creditors and enforcement authorities.

7.1.2. Registration

Cost and length of the registration process vary between Member States. While in some Member States, such as Belgium and Spain, it takes a maximum of 15 days and in Denmark it can take up to a maximum of 10 days from application to registration, in other Member States, it takes more than a month. For instance, in Portugal it can take up to 2 months to register a charge.[193]

The costs of the registration procedure should be divided into two main categories: the cost for the registration itself and other related costs for establishing the collateral (e.g. taxes and notary costs). The cost for the registration process varies considerably between Member States. For instance, the cost of registering a mortgage of EUR 100 000 in Greece is more than 25 times more than in Lithuania.[194] However, the registration costs alone are low compared to cost of entire registration process, with costs such as taxes and notary or other legal fees adding considerably to the overall amount. The size of additional costs varies though across Member States. Notary costs in the Netherlands are freely negotiable, making it possible to pay as low as EUR 268 for notary fees (based on a EUR 100 000 mortgage) where as in other countries, such as Belgium, the notary fees would be EUR 1 176.72.[195] However, in some Member States these costs remain small compared to the taxes payable for the constitution process. For instance, in Belgium a total of EUR 1 430 has to be paid in taxes for a EUR 100 000 loan, accounting for more than 50% of the total amount paid for the constitution and registration of the collateral, and in Spain EUR 1 000 for taxes, accounting for about two thirds of the total costs. The result is that the total amount paid for the constitution and registration of the collateral varies considerably between Member States. Studies estimate that total costs range from 0.15% (Poland) to 6% (Greece) for a EUR 100 000 loan.[196]

On-line registration, i.e. the possibility for a mortgage lender to register collateral on-line, does not, to our knowledge, exist in any Member State.

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191 Austria, England and Wales, Finland, Iceland, Ireland, Lithuania, the Netherlands, Norway, Scotland, Sweden. See http://www.eulis.org for more information.

192 England and Wales, Ireland, Lithuania, the Netherlands, Norway, Sweden. Nine more land information services are expected to be connected to the online service in 2007 and 2008 (Austria, Finland, Czech Republic, Iceland, Latvia, Poland, Scotland, Slovakia). There are certain difficulties for countries like France (no online service), Germany (land information is not public in an electronic form and no central register) and Spain that prevent those countries from joining EULIS. Information provided to the Commission by EULIS. See http://www.eulis.org for more information.

193 *Study on Efficiency of the Mortgage Collateral in the European Union*, European Mortgage Federation, 2007, p 11.

194 In Greece, the cost of registering a mortgage of EUR 100 000 is between EUR 820 and 950 compared to about EUR 30 in Lithuania. Source: European Land Registry Association.

195 Information provided by the European Land Registry Association.

196 Cf. footnote 193, p 12.

7.1.3. *Correctness and completeness of the register*

As mentioned before, the mortgage lender has an interest in accessing the land register in order to obtain information about all charges on the real estate. Land registers however do not always reflect accurately all charges that could affect property ownership rights. In some Member States, such as Austria, Belgium, Denmark, France, Germany, Portugal, Spain, Sweden, the Netherlands and the United Kingdom, charges exist that could affect property rights but are not reflected in the register (so called hidden charges). These hidden charges can be a result of either State claims (e.g. taxation) or other claims (e.g. an employee's right on the payment of salaries in the wake of an insolvency of the employer). For instance, in Belgium and Germany public charges on the property rank before any other registered claims, while in Portugal credits arising from labour contracts where the employer owes salaries to employees are privileged.[197]

7.2. Problem description

A mortgage lender will only engage in cross-border mortgage lending, if there is legal certainty surrounding the effects and nature of the charge, in particular that it can be accurately registered in the land register, and that the collateral can be accessed in the event of forced sale. Furthermore, both the consumer and the mortgage lender have an interest that the collateral can be established within reasonable time and cost both domestically and, for mortgage lenders, when operating cross-border.

7.2.1. *Cross-border access*

A basic element for every mortgage lender to assess the value of a property as a potential collateral is access to the land register where charges on the property are registered.

Based on information provided to the Commission, in no Member State are foreign mortgage lenders prevented from accessing national land registers at all. The ease of access depends, however, largely on the system in place. In systems with no online access, mortgage lenders operating cross-border will usually face higher costs than their domestically operating competitors. Processes such as requesting formal copies or undertaking personal enquiries take longer and are more expensive. This is a problem which is faced by many mortgage lenders since the majority of European land registers do not provide on-line access yet.

In a few Member States, such as Hungary and Latvia, centralised electronic land registers which can be accessed on-line by national mortgage lenders exist, however due to technical issues it is not yet possible or more difficult for foreign mortgage lenders to access those registers on-line, thereby discriminating mortgage lenders operating cross-border.

7.2.2. *Registration procedure*

Inefficient, lengthy and costly registration procedures have an impact on both consumers and mortgage lenders.

First, registration procedures have an impact when the security is established for the first time and – depending whether re-registering is necessary – when the borrower changes mortgage

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197 Comments provided by members of the Government Expert Group on Mortgage Credit: http://ec.europa.eu/internal_market/finservices-retail/home-loans/gegmc_comments_en.htm.

providers, i.e. if the beneficiary of the security changes. This impact is primarily on consumers who bear the cost of establishing the security (mortgage) for the loan.

Second, mortgage loans are commonly issued for 20 years or more. The long term duration of mortgage loans creates risks for the mortgage lender which need to be provided for. For a variety of reasons[198,] mortgage lenders may decide to sell all or part of their mortgage portfolios to another institution. While in the majority of Member States it is possible to transfer loan and security to a third party, it is frequently required to register the new beneficiary of the security.[199]

Inefficient and costly registration procedures impose costs on both consumer and mortgage lenders. For consumers, this raises the overall cost of taking out a mortgage credit and can eventually contribute to higher search costs and thus limiting customer mobility. For mortgage lenders, this raises funding costs and, consequently, makes loans more expensive.

7.2.3. Correctness and completeness of the register

As mentioned above, a mortgage lender willing to give a loan to a borrower must have the certainty that no other unregistered charges rank higher than the security established in favour of the mortgage lender. In all Member States, the principle of '1st in time, 1st in rank and priority' applies for establishing the creditor's ranking.[200] Mortgage lenders registering the first claim have therefore certainty about the value of the collateral that can be accessed in case a borrower defaults on his loan repayments. If, however, not all charges affecting the property are registered in the register, the level of legal certainty for mortgage lender is reduced because any non-registered charge which is preferential to the registered charge of the mortgage lender will lower the possible recovery value for the mortgage lender. For investors, this would also have consequences for the certainty with regard to the value of the collateral backing their securities.

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198 Cf. footnote 171, p. 57.

199 For more information on the transferability of mortgage loans see Section 10.3.

200 While in some Member States such as Poland, not only the day of the application is recorded for establishing the priority but also the hour and the minute, in other Member States only the day is determining for the rank. For instance, in Finland mortgages applied for on the same day have equal seniority unless otherwise declared on the application. Source: comments provided by members of the Government Expert Group on Mortgage Credit. See http://ec.europa.eu/internal_market/finservices-retail/home-loans/gegmc_comments_en.htm.

Table 41: Problems and consequences

Problem	Consequences
Different land registration systems create uncertainty for mortgage lenders: ▪ Lack of easy accessibility to land registers ▪ Inefficient, lengthy and costly registration procedures ▪ Existence of hidden charges	For consumers: – Expensive land registration procedures lead to higher costs. => Restricted customer mobility. For mortgage lenders: – Costs of cross-border access higher than domestic because of lack of online registers – Increased refinancing costs – limited scope for economies of scale – Uncertainty about the existence of hidden charges => Mortgage lenders may be deterred from cross-border activity => Reduced competition

7.3. Stakeholder's views

7.3.1. Consumers

Consumers support the EULIS project as such. They believe that the Commission should continue to finance EULIS.[201]

7.3.2. Mortgage lenders

Mortgage lenders support the EULIS project and argue that substantial efforts should be undertaken to encourage more countries to join.[202] Some mortgage lenders have asked the Commission to ensure equal access to mortgage registers in all Member States for domestic and foreign lenders in order to create a level playing field between lenders.[203] In this respect, they argue that the development of central and dematerialised registers should also be encouraged. Furthermore, mortgage lenders advocate the discontinuation of hidden mortgages and preferences in order to enhance transparency.

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201 Cf. footnote 35, p. 42.
202 Cf. footnote 35, p. 42.
203 Cf. footnote 171, p. 19.

7.3.3. Member States

The majority of Member States support the EULIS project. They are, however, divided in their views on whether the Commission should continue to finance EULIS.[204] The Member States opposed to further financing of EULIS are of the opinion that the users of EULIS should have to pay a transaction fee.

7.4. Objectives

The Commission seeks to:

- ensure non-discriminatory access to land registers;
- encourage the availability of on-line registers;
- encourage a reduction in the average duration and cost of registration procedures;
- encourage more transparency with regard to non-registered (hidden) charges.

7.5. Description of options

7.5.1. Option 1: Do nothing

Doing nothing would mean that all the problems identified in principle remain: mortgage lenders operating cross-border would face higher costs than domestically operating competitors for accessing land registers; lengthy and costly registrations procedures would impose costs on consumers and mortgage lenders, limiting customer mobility and increasing the cost of mortgage credit; and non-registered charges would continue to exist.

Existing initiatives, however, such as EULIS, which aims at providing easy cross-border access to information about ownership and interests in land and property via the Internet, could help to minimise the difficulties for mortgage lenders operating cross-border by providing access to information.

7.5.2. Option 2: Scoreboard

The Commission could collect information on the cost and duration of land registration procedures in all Member States. This information could be presented in a regularly updated 'scoreboard'. This 'scoreboard' could be made public in order to enable mortgage lenders to assess some of the costs and risks connected with land registration in other Member States.

7.5.3. Option 3: Recommendation

The Commission could invite Member States to ensure non-discriminatory access to their land registers, to ensure that land registers are available on-line and to envisage adhering to the EULIS project. In addition, it could be recommended that Member States review their land registration procedures to ensure that they are completed within a reasonable time limit

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[204] Cf. footnote 35, p. 42 and comments provided by members of the Government Expert Group on Mortgage Credit: http://ec.europa.eu/internal_market/finservices-retail/home-loans/gegmc_comments_en.htm.

and at a reasonable cost. The Commission could also recommend Member States to increase the transparency on non-registered charges which are preferential to the registered charge of the mortgage lender.

7.5.4. Option 4: Legislation

Legislation could be considered with the view to ensuring non-discriminatory access to land registers for mortgage lenders operating cross-border, to ensure that land registers are available on-line, to cap the cost and duration for the land registration process and to ensure more transparency with regard to non-registered (hidden) charges.

7.6. Impact assessment

7.6.1. Option 1: Do nothing

The work currently undertaken by EULIS could help mortgage lenders operating cross-border to access information on properties across Europe easily over the internet. Since EULIS also provides information about the legal conditions in different Member States, such as the possible existence of non-registered charges[205], EULIS improves the awareness of mortgage lenders of the likelihood that the possible recovery value could be smaller than expected. Although at the moment only six land information services (England and Wales, Ireland, Lithuania, Netherlands, Norway, Sweden) are accessible online through a single internet based portal, eight more land information services are expected to join in 2007 and 2008 (Austria, Finland, Czech Republic, Iceland, Latvia, Poland, Scotland, Slovakia).[206] Over time, it is likely that even more land registers join EULIS. However, some Member States, such as Belgium, France and Spain, are currently unable to become an active part of the on-line service of EULIS due to the current organisation of their land registers, for instance, because the land registers are not on-line yet. A connection to those land registration services is therefore not yet possible.

This option would impose costs for Member States willing to join EULIS in terms of adapting their land registers to the technology used by EULIS[207] and possibly to adapt legislation governing land registers to enable an exchange of information.

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205 http://www.eulis.org/aims.html.

206 Information provided to the Commission by EULIS.

207 EULIS uses a portal providing core information and connections to register services from the national systems. Information provided to the Commission by EULIS.

Table 42: Impacts of Option 1

Option	Affected parties Direct impact (D) Indirect impact (I)	Impacts ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	Timing One-off Short-term Medium-term Long-term	Nature Dynamic Static	Likelihood Certain High Medium Low
Do nothing	Consumers	≈/+ potential for ↓ prices from increased competition between mortgage lenders (I)	Long-term.	Dynamic.	Low
	Mortgage lenders (D)	≈/+ ↑ on-line access to property information across Europe on a non-discriminatory basis ≈/+ ↑ certainty as to recovery value because of information on potential non-registered preferential charges ≈ cost for land registration process because no change in efficiency of registration procedure	Medium to long term	Dynamic	Medium
	Investors (I)	≈/+ ↑ certainty as to recovery value because of information on potential non-registered preferential charges (I)	Medium to long term	Dynamic	Medium
	Member States (D)	– ↑ Cost for Member States willing to join EULIS	Medium to long term	Dynamic	Certain

7.6.2. *Option 2: Scoreboard*

The publication of a scoreboard would have several consequences. On the one hand, a 'scoreboard' could increase transparency for mortgage lenders in connection with the length and the costs for the registration of a mortgage deed in the different Member States. On the other hand, a scoreboard is only an information tool. A scoreboard cannot therefore lower the duration and the costs for the registration process as such. As such, it would therefore not be able to lower the funding costs connected with a sale of mortgage loans to a third party.

The scoreboard might however impose a certain peer pressure on Member States with lengthy and costly land registration procedures because the scoreboard clearly sets out in which countries the land registration procedures take the longest and impost the highest costs. As a result, those Member States might take action to increase the efficiency of their national land registration procedures and converge towards best practice.

The compilation of a scoreboard would impose costs on Member States who would be required to collect and provide the necessary data to the Commission.

Table 43: Impacts of Option 2

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Scoreboard	Consumers	≈/+ potential for ↓ prices from increased competition between mortgage lenders (I)	Long-term.	Dynamic.	Low
	Mortgage lenders (D)	≈/+ ↓ cost for land registration process due to higher efficiency (D) ≈ on-line access to property information across EU on a non-discriminatory basis (D) ≈ certainty as to recovery value because of information on non-registered preferential charges (D)	Medium to long term	Dynamic	Medium
	Investors (I)	≈ certainty as to recovery value because of information on non-registered preferential charges (I)	Medium to long term	Dynamic	Medium
	Member State (D)s	– ↑ cost for compiling and delivering data and eventually for improvement of national land registration procedures (D)	Medium to long term	Dynamic	Certain

7.6.3. Option 3: Recommendation

A recommendation to Member States could in general ensure that mortgage lenders enjoy non-discriminatory access to land registers across the EU, that national land registers can be accessed on-line and that Member States join the EULIS project. This would have a positive impact on cross-border lending activity.

A recommendation could also reduce the average duration and the average costs of land registration procedures, provided that Member States review their land registration process with the view to making it more efficient in terms of time and cost requirements. As a result, mortgage lenders could benefit from lower funding costs, if they choose to fund their mortgage loans with funding techniques which involve a sale of the mortgage loan and its security. Consumers benefit directly in form of lower costs for registering the mortgage deed when taking out a loan or switching providers, and indirectly if mortgage lenders pass their savings from lower funding costs to consumers in form of lower interest rates.

A recommendation could also increase the transparency on non-registered charges which are preferential to the registered charge of the mortgage lender. Member States could, for instance, ensure that the existence of hidden charges, which often stem from different laws, is clearly stated in the land register itself. This would raise the awareness of mortgage lenders that it may not be feasible, under certain circumstances, to fully recover the claim. With the knowledge that there are possible hidden charges lowering the value of the claim, a mortgage lender could specifically inquire whether such hidden charges are to expected with regard to a particular property and/or borrower and could adapt the offer to the borrower accordingly.

Against this background, a mortgage lender could limit to a certain extent the uncertainty as to whether any other unregistered charge ranks higher than the security established in favour of the mortgage lender. The recommendation could however not ensure that mortgage lenders do not face any non-registered charges at all which are preferential to the registered charge of the mortgage lender. Since most of the hidden charges are imposed for understandable reasons, such as the coverage of tax claims or employees' salaries in the wake of an insolvency of the employer, the Commission does not deem it appropriate to recommend a complete abolition of those charges. However, due to the nature of those charges it is also not always possible to register them in advance of the claim actually being made.

Member States would face a range of costs, when taking into account the recommendation. First, costs would be incurred for making any necessary changes in legislation to ensure that mortgage lenders enjoy non-discriminatory access to land registers in their countries in terms of time and resources in making their foreclosure procedures more efficient. Second, the transformation of land registers into electronic registers which can be accessed on-line will impose costs on Member States. Furthermore, Member States would incur costs for making their foreclosure procedures more efficient and for introducing measures which are designed to increase transparency with regard to hidden charges.

Table 44: Impacts of Option 3

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Recommendation	Consumers (D+I)	≈/+ ↓ cost for land registration process due to higher efficiency (D) ≈/+ ↓ prices (I)	Medium to long term	Dynamic	Medium (depends on whether Member States choose to act)
	Mortgage lenders (D)	≈/+ ↑ on-line access to property information across EU on a non-discriminatory basis (D) ≈/+ ↓ cost for land registration process due to higher efficiency (D) ≈/+ ↑ certainty as to recovery value because of information on non-registered preferential charges (I)	Medium to long term	Dynamic	Medium (depends on whether Member States choose to act)
	Investors (I)	≈/+ ↑ certainty as to recovery value because of information on non-registered preferential charges (I)	Medium to long term	Dynamic	Medium (depends on whether Member States choose to act)
	Member States (D)	– ↑ Cost for changes to land registration system and procedures (D)	Medium to long term	Dynamic	Medium (depends on whether Member States choose to act)

7.6.4. Option 4: Legislation

Legislation could ensure non-discriminatory access to land registers for mortgage lenders operating cross-border, which would have positive impact on the cross-border lending activity. In addition, legislation foreseeing that land registers must be accessible on-line for mortgage lenders would also benefit mortgage lenders willing to engage in cross-border lending. Caps on cost and duration of the registration process could make the registration process more efficient, therefore reducing the average duration and cost of registration procedures. This would benefit mortgage lenders and consumers alike. Any provisions aimed at increasing the transparency with regard to hidden charges would also benefit mortgage lenders.

Article 295 of the EC Treaty states that the Treaty shall in no way prejudice the rules in Member States governing the system of property ownership. It must however be recalled that, although the legal regime applicable to property ownership is a field of competence reserved for the Member States, it is not exempted from the fundamental rules of the Treaty.[208] Thus, any national measures governing the system of property ownership must comply with the provisions of the Treaty such as on the free movement of capital or services.

Member States would face costs for introducing the necessary changes in their national frameworks governing land registers and land registration procedures.

Table 45: Impacts of Option 4

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Legislation	Consumers(D+I)	≈/+ ↓ cost for land registration process due to higher efficiency (D) ≈/+ ↓ prices (I)	Medium to long term	Dynamic	High
	Mortgage lenders (D)	+/++ ↑ on-line access to property information across Europe on a non-discriminatory basis (D) + ↓ cost for land registration process due to higher efficiency (D) + ↑ certainty as to recovery value because of information on non-registered preferential charges(I)	Medium to long term	Dynamic	High
	Investors (I)	+ ↑ certainty as to recovery value because of information on non-registered preferential charges (I)	Medium to long term	Dynamic	High

208 Case C-300/01 Salzmann [2003] ECR I-04899, paragraph 39.

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
	Member States (D)	– ↑ Cost for implementing the provisions of the directive (D)	Medium to long term	Dynamic	Certain

7.7. Comparison of options

Options 1, 3 and 4 are the only options that have the potential to achieve all objectives of the Commission with respect to land registers. All other options fulfil only some of the objectives. Option 2 has the potential to lead indirectly to a reduction in the average duration and cost of registration procedures. Option 2 would provide information on the effectiveness of land registers in the different Member States and therefore impose a certain peer pressure on Member States to reconsider their land registration systems with the view to make them more efficient. Option 2 would therefore complement to Option 3.

Since Option 3 is of a non-binding nature, it is however unclear, to what extent Member States would follow the recommendations. This holds however true for all other options except Option 4. The impact of Option 1 depends on whether all Member States will join the EULIS project in the future. This is however uncertain because at least some Member States would have to undertake considerable changes to their land registration systems in order to be able to join EULIS. Since these changes would impose considerable costs for those Member States, Member States might be reluctant to undertake the necessary changes without any political support for EULIS, for instance from the Commission. Option 3 would therefore be a necessary intermediate step for the EULIS project to be fully successful.

In terms of costs, all options would impose costs for Member States for changing their land registers. Option 2 would impose additional costs for Member States in order to enable the regular compilation of data on the effectiveness of land registers. However, since such data would be necessary to control for the effectiveness of national land registration procedures and to identify those Member States, which set an example in terms of effectiveness, these costs appear to be inevitable. Compliance costs under Options 3 and 4 would be the highest, as they entail a commitment to increase transparency of hidden charges. In addition, the adoption of legislation would have to pass the legislative process and might therefore take a long time until it can be implemented by Member States.

In conclusion, a combination of Option 2 and 3 and seems the right approach to address the problems in connection with land registers. An all-encompassing legislative instrument on land registers as suggested under Option 4 appears to be at least at this stage to be disproportionate. Should however the suggested combination of Option 2 and 3 prove ineffective, the Commission could consider Option 4.

Table 46: Overview of policy option effectiveness

Option		Specific objective				General objectives				Comments
		Ensure non-discriminatory access to land registers	**Encourage the availability of on-line registers**	**reduction in the average duration and cost of registration**	**Encourage more transparency with regard to non-**	**Cross-border activity**	**Product diversity**	**Consumer confidence**	**Consumer mobility**	
1	Do nothing	≈	≈/+	≈/+	≈/+	≈/+	≈	≈	≈	Work currently undertaken by EULIS. Uncertainty whether all Member States will join in the future.
2	Scoreboard	≈	≈/+	≈	≈/+	≈/+	≈	≈	≈/+	Effectiveness dependent on reaction of Member States to peer pressure.
3	Recommendation	+/++	+/++	≈/+	≈/+	≈/+	≈	≈	+	Effectiveness uncertain because of non-binding character
4	Legislation	++	++	+	+	+	≈	≈	≈/+	

Assessment: ++ = strongly positive; + = positive; – – = strongly negative; – = negative; ≈ = neutral/marginal

8. APPLICABLE LAW

8.1. Context

The law applicable to contractual obligations is currently regulated by the Rome Convention of 1980[209]. On the basis of this Convention, a consumer who concludes a contract for the supply of goods or services is faced with a complex situation: the law applicable to the contract is, in principle, the one chosen by the parties, which often means in practice the law chosen by the provider in the standard terms and conditions. However, a consumer will, under certain conditions, benefit from the protection given by the mandatory provisions of the law of the country where he resides.[210]

Regarding the law applicable to mortgage deed, the principle of 'lex rei sitae' – the law of the country where the property is situated – applies.

209 Convention 80/934/EEC of 19 June 1980.
210 Article 5 of the Convention.

8.2. Problem description

8.2.1. Mortgage loan contract

Under the 1980 Rome Convention, three different laws may currently apply to a mortgage loan contract: the law of the home country of the mortgage lender; the law of the country where the property is located, the law of the country where the consumer is domiciled. This situation creates legal uncertainty for cross-border mortgage contracts for both mortgage lenders and consumers.[211]

Mortgage lenders and consumers however disagree as to what the appropriate solution should be. While mortgage lenders advocate that the applicable law for the mortgage loan contract should be defined by a general conflict of law rule based upon the principle of free choice, consumers strongly oppose such an approach and prefer the retention of the specific rules on consumer protection contained within the Rome Convention.[212] Mortgage lenders are of the opinion that the mandatory and systematic application of the law of the consumer's residence to cross-border mortgage loan contracts would suffocate market integration by obliging credit institutions to provide 27 different but competitive and cost-efficient mortgage products within the EU.[213] Consumers were sceptical about the free choice of contract law for consumers given the complexity and lack of knowledge about their own jurisdictions never mind other jurisdictions.[214]

8.2.2. Mortgage deed

Regarding the law applicable to the mortgage deed, no problem has been determined. The Forum Group on Mortgage Credit stated that the fact that the law applicable to the mortgage deed and the law applicable to the loan contract are governed by different jurisdictions is not an obstacle.[215] Furthermore, the application of the law of the country in which the property is situated (lex rei sitae) to the mortgage deed is widely supported.[216]

8.3. Objectives

The Commission seeks to remove the uncertainty surrounding the law applicable to mortgage credits thus improving consumer confidence and removing a barrier to the cross-border provision of mortgage credit.

8.4. Actions taken by the Commission

The Commission presented a proposal for a Regulation on the law applicable to contractual obligations[217]. The proposal will modify the rules on the law applicable to contractual obligations in contracts with consumers. One of the most important changes proposed is the establishment of the principle that the law of the country where the consumer resides habitually will apply to the contract if the provider pursues his commercial activities in the

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211 Cf. footnote 15, p. 21.
212 Cf. footnote 15, p. 23, Recommendations 20–21.
213 Cf. footnote 15, p. 22.
214 Cf. footnote 15, p. 22.
215 Cf. footnote 15, p. 22.
216 Cf. footnotes 15, p. 22 and 35, p. 33.
217 The proposal for a Regulation of the European Parliament and the Council on the law applicable to contractual obligations (Rome I), COM(2005) 650 final, 15.12.2005.

country where the consumer has his habitual residence.[218] The adoption of this Regulation would clarify the law applicable on mortgage loan contracts and remove the legal uncertainty with regard to cross-border mortgage contracts for both mortgage lenders and consumers. Assessment of the impact of the Regulation is undertaken within this initiative.

This modification mirrors the approach already taken in 2003 in the proposal for a Regulation on non-contractual obligations.[219] The approach followed there is to introduce Community provisions giving precedence to the law of the country where the damage arises or is likely to arise. In most cases, this corresponds de facto to the country where the consumer resides. This Regulation is complementary to the one on contractual obligations and together they should facilitate the solution of disputes in civil and commercial matters having a cross-border dimension.

9. USURY RULES AND INTEREST RATE VARIATION

9.1. Context

Interest rate restrictions generally take three forms: rate ceilings (caps) to prevent exorbitant interest rates for both, fixed and variable interest rate loans; limits on interest variability and restrictions on the use of compound interest rates.

Legally enforceable caps on interest rates, often termed 'usury' rules, are designed to prevent the charging of unreasonably high interest rates. The charging of usurious interest rates on mortgage credits can make repayment of loans difficult or impossible for borrowers. Historically, usury rules have been a common feature of European consumer protection legislation. Such rules have however gradually been replaced in many European countries by legislation dealing with unfair commercial practices and/or judicial decisions on abusive practices. In Germany, for example, usury lending can lead to the contract being declared null and void. According to German case-law, a contractual interest rate is void if it is at least 100% above the interest rate ranges customary on the market for loans of this type.[220] Usury laws do however still exist in a few European countries, for example, France, Italy, and Spain. In France, for example, a loan is considered to be usurious when its annual percentage rate at the time of granting is more than one third higher than the average percentage rate applied by credit institutions during the previous quarter for loans of the same type presenting a similar risk factor.[221] In Italy, interest rates that exceed that average market Annual Percentage Rate of Charge of the previous 3 months by 50% are prohibited.[222] In Spain, interest rates are considered to be invalid if 'markedly higher than normal' or 'disproportionate to the circumstances'.[223]

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218 Some areas remain excluded from the application of the proposed rule: life and non-life insurance Directives provide for specific laws of conflict and therefore these special rules will take precedence on the general regime. Denmark, Ireland and the United Kingdom are not part of the Convention and will not be covered by the Regulation (although the United Kingdom and Ireland have an opt-in clause).

219 Proposal for a European parliament and Council Regulation on the law applicable to non-contractual obligations (Rome II), COM(2003) 427 final, amended by COM(2006) 83 final, 21.2.2006.

220 See for more information http://ec.europa.eu/internal_market/finservices-retail/docs/home-loans/comments/ms-de_minjust-de.pdf

221 Article L313-3 of French Consumer Code, last amended: Order No 2005-1086 of 1.9.2005, Official Journal of 2.9.2005.

222 Law 108/1996.

223 Law of 1905.

Limits on interest variability are designed to protect borrowers from large shifts in interest rates. Restrictions on interest variability can be set either contractually or through a legislative act. In Belgium, for example, legislation requires that the cap can increase by a maximum of 1% (compared to the initial rate) during the 2nd year and by a maximum of 2% during the 3rd year.[224] Variable interest rate products with caps have also emerged in Germany and Denmark.[225] Such products also exist in the UK albeit accounting for only 0.6% of new mortgage loans in 2005.[226]

Compound interest is paid when interest is calculated each period on both the original amount and the interest previously accumulated. Restrictions on the use of compound interest rates exist in some Member States. In Greece, for example, compound interest is only legal if it is has been agreed for in the credit contract and if the compound interest is applied every six months. In France, compound interest is also legal albeit subject to certain conditions.[227]

9.2. Problem description

In more general terms, interest rate restrictions may affect competition in the market should mortgage lenders decide to offset interest rate restrictions with alternative fees or through the cross-subsidisation of products.

More specifically, a majority of financial institutions and intermediaries but a minority of other stakeholders[228] see interest rate restrictions as impeding product diversity and cross-border activity.

These stakeholders argue that product diversity is restricted in two main ways. First, interest rate restrictions may prevent the offering of certain products. Equity release products are, for example, commonly based on compound interest rates. In the UK, for example, certain types of equity release products rely on compound interest, as there is no repayment of interest during the life of the loan. Rules preventing the charging of compound interest or restricting its use, though conceived for the protection of consumers, might mean that certain products could not be offered throughout the European Union. Furthermore, during consultations, some stakeholders argued that such interest rate restrictions could act as a disincentive to product innovation.[229] Second, interest rate restrictions may also prevent the accessibility of mortgage credit for some categories of borrowers, in particular consumers with higher risk profiles. Prudential regulation, and in particular the Capital Requirements Directive, encourages the development of sound risk management. One key element of this is the use of risk-based pricing. Caps on the charging usurious interest could result, for example, in sub-prime borrowers or other customers with a poor credit history as well as the self-employed, being excluded from the market in the absence of specific social initiatives aimed at these categories.

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224 *Study on Interest Variability in Europe*, European Mortgage Federation, July 2006, p. 21.

225 Cf. footnote 224, p. 21.

226 Cf. footnote 224, p. 21.

227 According to Article 1154 of French Civil Code, interests due on capital may produce interest, either by a judicial claim, or by a special agreement, provided that, either in the claim, or in the agreement, the interest concerned be owed at least for one whole year.

228 67% of financial institutions and intermediaries, 27% of Member States and 29% of others argue that usury rules are a barrier to integration. No consumers stated that they were a barrier. Cf. footnote 35, p. 26.

229 Cf. footnote 35, p. 26.

In addition, this minority of stakeholders state that interest rate restrictions in one country could dissuade banks from other Member States from offering their services in that particular country if they are not able to charge risk-based prices for their products or if their standard products would be illegal, thereby hindering the cross-border provision of mortgage credit. This would be particularly important for niche mortgage lenders specialising in providing loans to sub-prime borrowers who would be unable to obtain the full economies of scale in offering their products.

At the same time, for a cap on interest rates to limit product diversity and/or cross-border activity, the level of the cap must be lower than the market rate which would be offered on a particular product. In this respect, no empirical evidence has been provided by stakeholders to date that the level of caps actually prevents the offering of certain products on a cross-border basis. Furthermore, there may be sound social or other reasons for a cap. These factors should be taken into account before determining whether caps represent a material problem or not.

In addition, and based on the evidence provided to date, restrictions on the use of compound interest rates primarily appear to affect the provision of equity release products. However, even in countries with restrictions on the use of compound interest, such as France, equity release products are emerging, for example, the 'credit hypothécaire rechargeable' and 'le prêt viager hypothécaire'. It is therefore difficult to argue that the interest rate restrictions themselves are prohibiting the offer of such products.

Finally, it should be emphasised that the number of countries concerned by interest rate restrictions is extremely limited. The large majority of Member States use unfair commercial practices legislation or other legislation with a similar effect to address usurious interest rates. Where interest rate restrictions exist, and as highlighted by the Green Paper contributions, they are also not specific to mortgage credit. Before their overall impact on the European mortgage market can therefore be calculated, these factors need to be taken into account.

Table 47: Problems and possible consequences

Problem	Consequences
Existence of interest rate restrictions: ▪ Interest rate caps (absolute and variability) ▪ Bans on compound interest rules	For consumers: – Limit consumer choice – Restrict access to mortgage products for certain borrowers For mortgage lenders: – Prevent the cross-border sale of mortgage products => limiting scope for economies of scale.

9.3. Description of options: Further research

The Commission will examine the need for and the justification of interest rate restrictions in particular taking into account consumer protection and their wider context.

10. MORTGAGE FUNDING

Mortgage lenders can finance the issuance of mortgage loans in a variety of ways, e.g. deposits, covered bonds, residential mortgage backed securities, whole loan sales and temporary warehousing facilities.[230]

Although detailed statistics on the funding structure of EU mortgage funding markets are scarce, retail deposits accounted in 2005 for approximately 70%[231] of mortgage funding and remain – and are likely to remain in the short to medium term – the predominant form of mortgage finance in the majority of Member States. Funding by residential and commercial covered bonds has been increasing rapidly in recent years and is estimated at about 17.5%[232], and funding by residential mortgage backed securities (excluding commercial mortgage backed securities) has also been increasing in recent years and is approximately 10% of outstanding EU residential mortgage balances.[233] The remainder of EU residential mortgages are assumed to be financed by unsecured lending.[234] The extent to which different funding techniques are used varies considerably between countries and depends on a variety of factors including the business strategy of the mortgage lender, the products offered by the mortgage lender and the regulatory framework for different funding instruments.[235] In general, mortgage lenders use a combination of complementary refinancing techniques.

Mortgage funding mechanisms impact on the integration of European mortgage markets in two ways.

First, by enabling mortgage lenders to choose the most appropriate funding strategy for their business and facilitating their use of secondary market financing, both domestic and cross-border mortgage funding activity could be made easier, thus improving the level of competition and efficiency of European mortgage markets, deepening the liquidity of the market and increasing the probability that these benefits will be passed on to consumers through lower prices.

The creation of larger and/or more diversified pools through either the pooling of loan portfolios from different countries or from several issuers have an economic rationale. Small to medium sized mortgage lenders that may struggle to achieve a critical mass on their own, would be able to access capital market funding more easily. Mortgage lenders who operate in several countries would be able to pool similar loans together without needing several issuances. Investors would also be able to directly purchase risk diverse portfolios. Furthermore, mortgage lenders would be able pool their assets and fund them away from local

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230 For further explanation of the characteristics of different products, see footnote 171, p. 4 and Annex p. 44.

231 Raw estimates on the basis of 2005 data from *HYPOSTAT 2005: A review of Europe's Mortgage and Housing Markets*, European Mortgage Federation, November 2006.

232 *Covered Bonds beyond Pfandbriefe*, Ed. Jonathan Golin, Euromoney 2006 based on data from the European Mortgage Federation. At the end of 1997, there was in excess of EUR 100 billion in outstanding covered bonds. By the end of 2000, this figure had increased to about EUR 600 billion. According to the *European Covered Bond Fact Book*, European Covered Bond Council, August 2006, the volume of outstanding covered bonds at the end of 2005 amounted to almost EUR 1.8 trillion.

233 Cf. footnote 171, p. 3.

234 Cf. footnote 171, p. 3.

235 For further explanation of the characteristics of different products, see footnote 171, p. 4 and Annex p. 44.

deposit markets – should they so wish – in order to find the most efficient and appropriate funding instrument for their particular needs.

The range of mortgage providers would also tend to be broadened. Institutions who are not credit institutions (and are therefore not licensed to collect and thus fund their mortgage lending activities using deposits) but would like to provide mortgage credit would be able to do so using capital market funding instruments.[236] Credit institutions seeking to enter a new (non-domestic) mortgage market would also be able to access capital market funding instruments to finance mortgage loans without the need to first develop a deposit base.

Second, the funding mechanism used to finance the mortgage loan can impact on the type of products available.[237] The diversity of financing techniques in Europe has already enabled the provision of a wide range of mortgage products to consumers. With the use of capital market funding mortgage lenders are able to develop and fund new risk-based products, directed at borrowers in the lower income brackets and/or with poor credit histories. Capital market funding can therefore broaden the range of products available for consumers to choose from.

European mortgage lenders already make use of capital market funding techniques in order to increase market share and profitability, reduce the overall risk exposure and increase performance and effectiveness. However, mortgage lenders seeking to access capital markets and fund their mortgage business using capital market funding products face certain challenges, especially when engaging in cross border activity. These problems generally fall into two categories: primary market issues and secondary market issues. Primary market issues are treated in other sections of this report.[238] This section will therefore exclusively examine the specific problems faced by mortgage lenders in secondary markets.

10.1. Covered bonds

10.1.1. Context

Covered bonds are debt instruments secured by a cover pool of eligible assets such as mortgage loans (property as collateral) or public-sector debt to which investors have a preferential claim in the event of default.[239] While the nature of this preferential claim, as well as other safety features (asset eligibility and coverage, bankruptcy-remoteness and regulation) depends on the specific framework under which a covered bond is issued, it is the safety aspect that is common to all covered bonds.

Based on the safety aspect, non-structured covered bonds enjoy privileged treatment under the Directive on Undertakings for Collective Investments in Transferable Securities (UCITS Directive)[240] whereby UCITS can invest up to 25% (instead of max. 5%) of their assets in covered bonds of a single issuer that meet the criteria of Article 22(4)[241] Furthermore, the

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236 See Section 11. (non-credit institutions and servicers).

237 Cf. footnote 171, p. 1.

238 See for example, Sections 4. (credit registers), 5. (property valuation), 6. (forced sales procedures) and 7. (land registration).

239 For more information on what covered bonds are, how they work and the rationale for issuing them, see footnote 171, p. 44.

240 Directive 85/611/EEC, 20.12.1985.

241 According to Article 22(4) of Directive 85/611/EEC, Member States may raise the 5% limit laid down in the first sentence of paragraph 1 to a maximum of 25% in the case of certain bonds when these are issued by a credit institution which has its registered office in a Member State and is subject by law to

Capital Requirement Directive establishes a specific treatment for non-structured covered bonds according to which covered bonds have beneficial credit risk weightings if they fulfil certain requirements.[242]

10.1.2. Problem description

10.1.2.1. Non-existent legal framework in some Member States

Covered bonds have gained importance in recent years as a means to refinance residential mortgage loans. In 2005, funding of residential and commercial mortgages by covered bonds[243] was estimated at about 17.5% across 15 Member States and Switzerland. However, huge differences in the issuance of covered bonds exit between Member States with covered bond legislation[244] and Member States without such a legal framework. In countries with a covered bond legal framework,[245] such as Denmark, the Czech Republic, Hungary, Sweden, Spain and Germany, funding of mortgage loans through covered bonds is well above the average of 17.5% reaching in Denmark almost 100%.[246] In countries without a legal framework, constituting the minority in the EU,[247] such as the Netherlands or the United Kingdom, funding through covered bonds remains far behind the European average, reaching not even 5%.[248] Taking into account the size of the collateral pools and the level of development of mortgage markets in the Netherlands or the United Kingdom, the low level of covered bond funding might be at least to some extent rooted in the lack of a legal framework

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special public supervision designed to protect bond-holders. In particular, sums deriving from the issue of these bonds must be invested in conformity with the law in assets which, during the whole period of validity of the bonds, are capable of covering claims attaching to the bonds and which, in the event of failure of the issuer, would be used on a priority basis for the reimbursement of the principal and payment of the accrued interest.

242 To qualify covered bonds must comply with the standards of Article 22(4) of Directive 85/611/EEC; the asset pools that back the covered bonds must be constituted only of assets of specifically-defined types and credit quality; and the issuers of covered bonds backed by mortgage loans must meet certain minimum requirements regarding mortgage property valuation and monitoring, see Directive 2006/48/EC, 14.6.2006, Annex VI, paragraphs 68–71.

243 No figures available for residential covered bonds only. See footnote 171, p. 3.

244 The legal framework can either take the form of specific mortgage acts, or can be integrated in other legislation, establishing safeguards to protect bondholders against the risk of the insolvency of the issuer and the risks that might create cash flow imbalances between the cover asset pool and the covered bonds.

245 For an overview of covered bond legislation in Europe see *European Covered Bond Fact Book*, European Covered Bond Council, August 2006, p. 18. Nineteen Member States have covered bond legislation in place.

246 The figure refers to residential and Commercial Mortgage Covered Bonds outstanding as a percentage of mortgage loans in 2005. See footnote 171, p. 47.

247 No covered bond legislation currently exists in the Netherlands, the United Kingdom, Estonia, Slovenia, Belgium, Slovakia, Malta and Cyprus. However, the UK Financial Services Authority and UK Treasury published in July 2007 a joint consultation on a proposal for a UK recognised Covered Bonds legislative framework which is expected to come into force on January 2008. See http://www.hm-treasury.gov.uk/consultations_and_legislation/ukrec_covbonds/consult_ukrec_covbonds.cfm.

According to the Dutch Ministry of Finance, the Netherlands are currently considering the implementation of covered bond legislation. See http://ec.europa.eu/internal_market/finservices-retail/home-loans/mortgage_comments_en.htm. In addition, according to the European Covered Bond Council, Slovenia is also currently preparing covered bond legislation and Estonia is also considering introducing one. See *European Covered Bond Fact Book*, European Covered Bond Council, August 2006, p. 18.

248 At the beginning of 2006, ABN Amro remained the only covered bond issuer in the Netherlands. *European Covered Bond Fact Book*, European Covered Bond Council, August 2006, p. 95.

specific to covered bonds in these countries. Given the fact that mortgage credit is growing faster than deposits (118% compared to 43% since 1999), there is an emerging need for alternative funding measures. It is however important that alternative methods can develop especially for longer-term fixed-rate mortgage funding, which avoid interest rate mismatch for mortgage lenders.[249] In Member States where no legal framework for covered bonds exists, mortgage lenders might have to turn to alternative refinancing sources. These could potentially be more expensive, leading to higher prices for consumers.

The absence of a specific legal framework for covered bonds could also impact on product diversity, especially on the availability of long-term fixed-rate mortgage products for consumers, if mortgage lenders are not able to match fixed-rate cash flows on the assets side (interest payments made by the borrower) with fixed-rate liabilities. Furthermore, the absence of a specific framework for covered bonds could be an obstacle to recognition of covered bonds under the UCITS Directive, affecting the extent to which European funds could invest in them and therefore impacting on the demand from investors for those funding instruments.[250] Lower demand from investors for covered bonds issued outside any specific covered bonds framework could also affect the use of covered bonds as a potential route through which mortgage lenders could fund longer-term fixed-rate mortgage lending, therefore impacting on funding costs and product diversity as described before.

10.1.2.2. Collateral instrument limitations

Existing national covered bond laws impose several limitations regarding the base of eligible assets that qualify for covering covered bonds such as the type of borrower (public/private borrowers), the type of underlying security (mortgage/ship loans), maximum exposure to certain borrowers, geographical scope of mortgages, maximum LTV ratios, etc. All of these limitations are in principle safeguards to ensure the high credit quality of cover pools and, consequently, to offer a relatively low credit risk for bondholders. However, in some instances, such as in Spain[251] and Poland[252], provisions exist which prohibit the inclusion of mortgage loans which are secured by mortgages on property located in other EU countries in cover pools while in other Member States with covered bond legislation such limitations do not exist. This restriction may constitute an infringement of the Treaty provisions governing the free movement of capital.[253] The limitations with regard to asset eligibility impact on the incentive for Spanish and Polish mortgage lenders which refinance their mortgage loans via

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249 For further information, see Annex 1.

250 Cf. footnote 110, p. 77.

251 In Law 2/1981 of March 1981 on the Regulation of Mortgage Markets there is no explicit constraint in the location of the property. However, the formal requirement that the mortgage on the property has to be inscribed into the *Registro de la Propiedad* (Spain's Property Land Register) automatically eliminates the possibility of including foreign mortgages (Article 28 of Royal Decree 685/1982 of 17 March 1982 developing certain aspects of Law 2/1981 of March 1981 on the regulation of the mortgage market). The Spanish Mortgage Law is however currently under review. The current draft contains an expansion of the geographical scope of eligible mortgages to include properties located in the European Union, subject to the security being similar in nature to that in Spain.

252 Article 2(2) of the Act on mortgage bonds and mortgage banks of 29.8.1997, Journal of Law no. 99, item 919, defines a mortgage as a mortgage collateral established in the name of a mortgage bank against the right of perpetual usufruct or the right of ownership to a property situated within the country, see http://www.hypo.org/DocShareNoFrame/docs/1/LNNDLGGABLHPCKGOLKEHFHOCPDBN9DBYB6TE4Q/EMF/Docs/DLS/2006-00103.pdf.

253 In particular, Article 56 of the Treaty provides that '...all restrictions on the movement of capital between Member States shall be prohibited.'.

the issuance of covered bonds to engage in cross-border business. Although Spanish and Polish mortgage providers could offer their mortgage products to consumers in other Member States, the incentive to do so would be limited because those loans would have to be refinanced by other, potentially more expensive refinancing instruments. The limitation therefore imposes a barrier for Spanish and Polish covered bond issuers seeking to engage in cross-border mortgage lending business and consequently impacts on the level of competition on mortgage markets. Furthermore, it creates an uneven level playing field between mortgage lenders across the EU.

Table 48: Problems and consequences

Problem	Consequences
Covered bond frameworks: ▪ Non-existent legal framework for covered bonds in some Member States ▪ Limitations to the type of collateral that can be put in a covered bond pool	For mortgage lenders: – Increased refinancing costs – limited scope for economies of scale => Mortgage lenders may be deterred from cross-border activity => Mortgage lender may be deterred from offering certain products, e.g. long-term fixed rate products => Reduced competition For consumers: – Limited consumer choice, in particular with regard to long-term fixed rate products – Higher prices – For investors: – Restricted investment opportunities => Reduced demand

10.1.3. Objectives

The Commission aims to:

- facilitate the development of a wide range of mortgage funding instruments; and
- ensure the acceptance of mortgage loans which are secured by mortgages on properties located in other EU jurisdictions as eligible assets in cover pools without endangering the high credit standards in covered bond issuance frameworks.

10.1.4. Description of options

10.1.4.1. Option 1: Do nothing

<u>Non-existent legal framework in some Member States</u>

Four (Estonia, the Netherlands, Slovenia and the United Kingdom) out of the eight Member States where no framework for covered bonds exits, are either considering or are already preparing the introduction of a legal framework for covered bonds. Even without any intervention from the Commission, the number of Member States without a legal framework for covered bonds might therefore be lower in the near future.

<u>Collateral instrument limitations</u>

Without any intervention from the Commission, the collateral instrument limitation with regard to type of collateral that can be put in a covered bond pool will in principle remain. However, one of the two countries (Spain), which currently prohibit, according to the information available, the inclusion of mortgage loans which are secured by mortgages on property located in other EU countries in cover pools, is currently reconsidering this restriction within the review of their Mortgage Act. Even without any action from the Commission, the problem of legal limitations on the type of collateral is therefore likely to be solved in at least one of the two Member States identified as having such limitations in their national provisions.

10.1.4.2. Option 2: Enforce existing legislation

The Commission could pursue infringement procedures against those Member States which limit in their covered bond legislation the base of eligible assets to mortgage loans which have been secured by mortgages on domestic properties. This would imply an analysis whether the exclusion of non-domestic EU mortgage loans in cover pools is incompatible with the free movement of capital guaranteed under the EC Treaty or whether any objectives which may be brought forward by Member States, such as ensuring high safety features for the benefit of investors in covered bonds, justify an exclusion of non-domestic EU mortgage loans.

10.1.4.3. Option 3: Recommendation

The Commission could encourage the introduction of covered bond legislation in those Member States which do not yet have a legal framework for covered bonds in place. This could be done through the adoption of a Recommendation.

10.1.4.4. Option 4: Legislation

The Commission could consider adopting a Directive on covered bonds. This Directive could require all Member States to introduce a covered bond legal framework.

If the Commission considers adopting a directive on covered bonds, a provision specifying which mortgage loans are eligible as cover assets for covered bonds could be included to ensure that unjustified collateral instrument limitations could not be imposed by national law.

10.1.4.5. Option 5: Develop an optional European regime (28th regime)

The Commission could consider the development of an optional European covered bond framework (a so-called '28th regime'[254]) that could be used by mortgage lenders as an alternative to existing national covered bond frameworks. In an optional European regime, the eligibility of cover assets could be determined on a non-discriminatory basis.

10.1.5. Impact assessment

10.1.5.1. Option 1: Do nothing

Non-existent legal framework in some Member States

Half of the Member States (Estonia, the Netherlands, Slovenia and the United Kingdom) without a legal framework for covered bonds are currently considering introducing or are preparing to introduce such framework in the near future. Only four Member States (Belgium, Cyprus, Malta, and Slovakia) do not currently appear to foresee the introduction of a legal framework on covered bonds. For some of those Member States, namely Cyprus and Malta, the size of their mortgage credit markets and the resulting volume of mortgage credits to be used as cover assets might however not justify the costs of introducing a legal framework for covered bonds including its subsequent supervision.

For those countries without a covered bond framework, the problems identified would remain. Mortgage lenders in countries without such a framework would be unable to use covered bonds as an alternative mortgage refinancing instruments, potentially leading to consumer detriment in terms of product diversity and prices.

UCITS would still be unable to invest as much as 25% of its assets in covered bonds of one single issuer in countries without a covered bond framework, because those covered bonds are not recognised under the UCITS Directive.

Collateral instrument limitations

Without any action from the Commission, mortgage lenders would be prevented from including mortgage loans which are secured by mortgages on property located in other EU countries in their cover pools. Mortgage lenders in countries with such restrictions, such as Poland and Spain, would not have an incentive to engage in cross-border mortgage lending business which would in principle impact on the level of competition on mortgage markets. As a result, consumers might face some detriment through below potential competition, possibly slightly higher prices or the absence of certain products.

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[254] 28th regimes are legal frameworks of EU rules which do not replace national rules but are an optional alternative to them (e.g. European Company Statute).

Table 49: Impacts of Option 1

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Do nothing	Consumers (I)	≈/+ ↑ product diversity (I) ≈/+ ↓ prices (I)	Medium to long term	Dynamic	Medium
	Mortgage lenders (D)	≈/+ ↑ use of covered bonds as alternative funding instrument (D)	Medium to long term	Dynamic	Medium
		≈/+ ↑ use of mortgages on non-domestic property (D)	Medium to long term	Dynamic	Medium
	Investors (I)	+ ↑ level of investment into covered bonds for investment funds in Member States with covered bond legislation if fulfilling conditions in Article 22(4) UCITS (I)	Medium to long term	Dynamic	Medium
	Member States (D)	– ↑ cost for introduction/amendment of covered bond legislation (D)	Medium to long term	Static	Uncertain

10.1.5.2. Option 2: Enforce existing legislation

The exclusion of non-domestic EU mortgage loans in cover pools might not be compatible with the free movement of capital guaranteed under the EC Treaty and could possibly lead to the result that any provisions in national law excluding the eligibility of non-domestic EU mortgage loans infringe the EC Treaty provision on the free movement of capital and are not justified by other objectives, such as ensuring high safety features for the benefit of investors in covered bonds. Without anticipating the result of an investigation in this respect, the fact that the majority of Member States with covered bond legislation in place do not exclude mortgage loans which are secured by mortgages on non-domestic property located within the European Union might be an indicator that such assets are not impairing the claims of investors.

In enforcing existing legislation, the Commission would seek to identify whether other Member States, besides Poland and Spain, have such national provisions in place and consider to what extent action against those Member States in order to lift the ban on the inclusion of non-domestic EU mortgage loans is required. If the ban were lifted, mortgage lenders in Member States concerned using covered bonds as refinancing instrument would then have the opportunity to use mortgages on non-domestic EU property in their cover pools. This would ensure a level playing field between mortgage lenders and could provide an incentive for those mortgage lenders currently prevented from including non-domestic EU mortgage loans in their cover pools to go cross-border. Consumers would potentially benefit from more competition on their mortgage markets.

If it were established that such rules were contrary to Treaty obligations, those Member States who currently forbid the inclusion of non-domestic assets in cover pools, would be required to adapt their national covered bond legislation thus entailing some costs.

Table 50: Impacts of Option 2

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Enforce existing legislation	Consumers (I)	≈/+ ↑ product diversity (I) ≈/+ ↓ prices (I)	Medium term	Dynamic	Uncertain (dependent on the outcome of investigation)
	Mortgage lenders (D)	+ ↑ use of mortgages on non-domestic property (D)	Medium term	Dynamic	Uncertain (dependent on the outcome of investigation)
	Investors (I)	? maintaining high credit standard of covered bond framework (I)	Medium term	Dynamic	Uncertain (dependent on the outcome of investigation)
	Member States (D)	– ↑ cost for amendment of covered bond legislation (D)	Medium term	Static	Uncertain (dependent on the outcome of investigation)

10.1.5.3.Option 3: Recommendation

Promoting the introduction of covered bond legislation in those Member States which do not have a legal framework for covered bonds could encourage those Member States without covered bond frameworks to consider adopting covered bond legislation.

The introduction of covered bond legislation would give mortgage lenders in those countries the possibility to issue covered bonds within a covered bond framework. This could lead to indirect benefits for consumers and certain investors. Consumers could possibly benefit from lower prices and a wider range of products. Investment funds could invest up to 25% of their assets in covered bonds issued by the same body provided that the covered bond framework fulfils the conditions of Article 22(4) of the UCITS Directive. Member States would incur administrative costs in terms of time and resources in introducing covered bond legislation.

Table 51: Impacts of Option 3

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Recommendation (with regard to introduction of covered bond laws)	Consumers (I)	≈/+ ↑ product diversity (I) ≈/+ ↓ prices (I)	Medium to long term	Dynamic	Medium
	Mortgage lenders (D)	+ ↑ use of covered bonds as alternative funding instrument (D)	Medium to long term	Dynamic	Medium
	Investors (I)	+ ↑ level of investment into covered bonds for investment funds in Member States with covered bond legislation if fulfilling conditions in Article 22(4) UCITS (I)	Medium to long term	Dynamic	Medium
	Member States (D)	– ↑ cost for introduction of covered bond legislation (D)	Medium to long term	Static	Medium

10.1.5.4.Option 4: Legislation

Non-existent legal framework in some Member States

A European harmonised framework on covered bonds, containing a number of certain provisions detailing requirements for covered bond issuance would fulfil the objective of facilitating the development of a wide range of mortgage funding instruments because it would oblige Member States, who do not yet covered bond legislation in place, to introduce one. This would give mortgage lenders in those countries the possibility to use covered bonds, issued under a legal framework, as an alternative refinancing instrument. Both consumers and certain investors would benefit: consumers through potentially lower prices and a wider range of products and investors by widening the range of investment opportunities. Member States without any covered bond framework would however face certain costs in introducing covered bond legislation.

However, the adoption of a Directive would also impact on Member States that already have covered bond legislation in place. Those Member States might also have to reconcile their national systems with the new legislation. The scope and extent of such would depend largely on the number of provisions in a Directive on covered bonds and their compatibility with the national law. A Directive would therefore impact on well-functioning national covered bond systems, some of which have been in place for a very long time. In addition, the implementation of a Directive would entail costs for Member States that already have covered bond legislation in place. Since the number of Member States with a legal framework on covered bonds in place is much higher than the number of Member States without a legal framework, a lot of additional costs would be created by the introduction of a European harmonised framework on covered bonds. By the time a European harmonised framework will be adopted, even more Member States might have introduced legal frameworks on covered bonds, increasing the aggregated costs of changing national laws even further.

Mortgage lenders currently issuing covered bonds under their existing national laws might also face some costs when new European rules force Member States to adapt their national legislation because of – depending on the range of issues covered in a Directive – possibly required changes with regard to the issuance of covered bonds, such as eligibility of cover assets, asset-liability management guidelines, segregation of assets and bankruptcy remoteness, monitoring of cover pool, etc.

Collateral instrument limitations

A European harmonised framework on covered bonds, determining the base of eligible assets that qualify for covering covered bonds in the legal process, would ensure that unjustified collateral instrument limitation could not be imposed by national law. Mortgage lenders in Member States where the use of certain cover assets is currently limited without justification, such as possibly the limitation to mortgages on domestic property, could then use a broader range of collaterals as cover assets for their covered bonds. This could have the positive implications for consumers from increased competition as described above.

As explained above, the introduction of a European harmonised framework would however entail costs for certain stakeholders. Although a possible provision establishing the eligibility of mortgages on non-domestic property as a cover asset might lead only to a few Member States having to change their covered bond legislation, it is highly unlikely that a European harmonised framework on covered bonds would be deal with this issue alone. On the contrary, it would be more likely that a Directive would have a wider scope. Consequently, Member States with a legal framework on covered bonds in place might face considerable costs adapting their covered bond laws as mentioned above. Mortgage lenders currently issuing covered bonds under their existing national laws might also face some costs if new European rules were to force Member States to adapt their national legislation as explained above.

Table 52: Impacts of Option 4

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Legislation	Consumers (I)	≈/+ ↑ product diversity (I) ≈/+ ↓ prices (I)	Medium to long term	Dynamic	High
	Mortgage lenders (D)	? ↑ use of covered bonds as alternative funding instrument for some mortgage lenders (D) – ↑ cost for other mortgage lenders to amend their process to comply with new legislation	Medium to long term	Static (costs) and Dynamic (benefits)	Uncertain (dependent on the content of the Directive)
		+ ↑ use of mortgages on non-domestic property (D)	Medium to long term	Dynamic	Certain

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
	Investors (I)	++ ↑ level of investment into covered bonds for investment funds in Member States with covered bond legislation if fulfilling conditions in Article 22(4) UCITS (I)	Medium to long term	Dynamic	Certain
		? maintaining high credit standard of covered bond framework (I)	Medium to long term	Dynamic	Uncertain (dependent on the content of the Directive)
	Member States (D)	– ↑ cost for introduction/amendment of covered bond legislation (D)	Medium to long term	Static	Certain

10.1.5.5. Option 5: Develop an optional European regime (28th regime)

The development of an optional European covered bonds framework could also ensure that all mortgage lenders, including those without national covered bond frameworks, could potentially access covered bonds as an alternative refinancing instrument thereby creating a level playing field. While not obliging Member States with limitations on cover pool assets to lift their requirements, mortgage lenders in such Member States could use the optional European covered bonds framework as an alternative for mortgages on non-domestic EU property. An optional European covered bonds framework would however require an in-depth economic and legal assessment of the expected benefits and the possible obstacles to the creation of such structure. Such an instrument would be a very complex issue, touching on areas such as bankruptcy proceedings, special public supervision, property and contract law, etc.

If designed in the right way, an optional European covered bonds framework could serve as an additional mortgage funding instrument for mortgage lenders, therefore providing indirect benefits for consumers in terms of product diversity and prices. However, while the acceptance of such a new instrument by investors would clearly depend on the credibility of any safety features of the new instrument ensuring the preferential claim of a covered bond investor, it would certainly take some time for investors accept an optional covered bond instrument as a full alternative to well established national covered bonds.

Table 53: Impacts of Option 5

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Develop an optional European regime (28th regime)	Consumers (I)	≈/+ ↑ product diversity (I) ≈/+ ↓ prices (I)	Medium to long term	Dynamic	Uncertain
	Mortgage lenders (D)	+ ↑ use of covered bonds as alternative funding instrument (D)	Medium to long term	Dynamic	Uncertain
		+ ↑ use of mortgages on non-domestic property (D)	Medium to long term	Dynamic	Uncertain
	Investors (I)	?	n.a.	n.a.	Uncertain
	Member States (D)	?	n.a.	Static	High

10.1.6. Comparison of options

Option 1 would partly fulfil the objective of the Commission to facilitate the development of a wide range of mortgage funding instruments. However, the recent developments with regard to the possible introduction of a covered bond framework in a couple of Member States seem to indicate that Member States consider the merits of covered bonds as alternative refinancing instruments and reacting accordingly with a discussion of a legal framework in this respect. Option 1 cannot however ensure that unjustified collateral instrument limitations with regard to the location of the mortgaged property will not prevail in the future. However, at least one Member State might lift the legal limitation in this respect in the near future without any intervention from the Commission.

If an analysis of the cases in question reached the conclusion that the exclusion of non-domestic EU mortgage loans in cover pools is incompatible with the free movement of capital guaranteed under the EC Treaty, then Option 2 could potentially ensure that unjustified collateral instrument limitations with regard to the location of the mortgaged property would be abolished. This option has therefore, in contrast to Option 1, the potential to help remove the barriers to the creation of international covered bond pools. Member States required to amend their legislation would face some costs, however, the benefits of improved market efficiency should prevail.

Option 3 might lead Member States without covered bond legislation to consider the introduction of a covered bond framework. However, it seems to be doubtful whether this option is more effective than Option 1 because of the non-binding character of a recommendation. With both Option 1 and 3, there is however the likelihood that certain Member States refrain from adopting a national covered bond framework due to the size or scope of their mortgage markets. This could lead to arguments about the lack of a level playing field between Member States.

On the one hand, Option 4 would ensure that all Member States have covered bond legislation in the future, thereby allowing all mortgage lenders to be able to issue covered bonds under a legal framework if they should so wish. Option 4 would in principle also ensure that unjustified collateral instrument limitations would be abolished. On the other hand, a Directive would change existing national covered bond laws without any apparent need to do so and would impose considerable costs for Member States with covered bond laws on place. In addition, the adoption of a Directive would have to pass the legislative process and might therefore take a long time until it can be implemented by Member States. By this time, the problem of non-existent legal frameworks on covered bonds and/or unjustified collateral instrument limitations might have already been reduced considerably.

Similar arguments can be presented for Option 5. While it would achieve the objective of enabling all mortgage lenders to – should they so wish – use covered bonds as an alternative refinancing instrument, as well as facilitate the use of mortgages on non-domestic EU property as a cover asset for a covered bond by mortgage lenders without requiring Member States with limitations on cover pool assets to lift their requirements, considerable legal and economic work would have to be undertaken before such as proposal could be made. By which point, the problem of non-existent legal frameworks on covered bonds might have already been reduced considerably. However, such a response would appear disproportionate to the problem in question as its consequences would go far beyond the problem identified with potential implications for other Member States as explained above.

Although both Options 4 and 5 would help fulfil the aims of the Commission, their potential costs to the markets and in terms of their development are likely to outweigh the benefits accrued.

In conclusion, in terms of facilitating the use of a wide range of mortgage funding instruments, whilst Options 4 and 5 would create a level playing field between mortgage lenders across Europe by enabling mortgage lenders to issue covered bonds, both options appear disproportionate to the scope of the problem. Half of the Member States currently without covered bond frameworks are currently working on introducing them. Given these developments, it remains to be seen whether the remaining countries will consider introducing such a framework in the future. At this point in time therefore, Option 1 appears preferable compared to Option 3 because it is at least partly fulfilling the objectives of the Commission and has no negative impact on stakeholders.

Table 54: Overview of policy option effectiveness

Option	Specific	General				Comments
	Facilitate the development of a wide range of funding instruments	Cross-border activity	Product diversity	Consumer confidence	Consumer mobility	
Option 1: Do nothing	+	+	+	≈	≈	Several Member States are considering the introduction of covered bond legislation. Spain is reconsidering its rules on the eligibility of cover assets.
Option 3: Recommendation	≈/+	≈	≈/+	≈	≈	Effectiveness uncertain because of non-binding character
Option 4: Legislation	?	?	?	≈	≈	Benefits from introducing new national frameworks in some Member States might be outweighed by the costs for changes of existing covered bond legislation.
Option 5: Develop an optional European regime (28th regime)	?	?	?	≈	≈	Effectiveness and efficiency uncertain.

Assessment: ++ = strongly positive; + = positive; – – = strongly negative; – = negative; ≈ = neutral/marginal; ? = uncertain

Table 55: Overview of policy option effectiveness

Option	Specific	General				Comments
	Ensure the acceptance of mortgages on non-domestic property as cover assets	Cross-border activity	Product diversity	Consumer confidence	Consumer mobility	
Option 1: Do nothing	≈/+	+	+	≈	≈	
Option 2: Enforce existing legislation	?	?	?	≈	≈	Depends on outcome of investigation on collateral instrument limitation.
Option 4: Legislation	?	?	?	≈	≈	Benefits from introducing new national frameworks in some Member States might be outweighed by the costs for changes of existing covered bond legislation.
Option 5: Develop an optional European regime (28th regime)	?	?	?	≈	≈	Effectiveness and efficiency uncertain.

Assessment: ++ = strongly positive; + = positive; – – = strongly negative; – = negative; ≈ = neutral/marginal; ? = uncertain

10.2. Residential mortgage backed securities

10.2.1. Context

A residential mortgage backed security (RMBS) can broadly be defined as a security issued by or on behalf of a special purpose vehicle (SPV) which is backed by an identified pool of mortgage loans transferred from a mortgage lender to that vehicle in return for cash (cash RMBS) or kept on the balance sheet of the mortgage lender with only the credit risk being transferred to that vehicle (synthetic RMBS).[255] This security is sold to investors in the public and private markets.

Securitisation is however much wider than just residential mortgage backed securities since the basic concept of securitisation may be applied to virtually any asset that has a reasonably ascertainable value and that generates a reasonably predictable future stream of revenue. The problems identified in this section therefore also apply in most cases to other asset backed securities.[256]

Residential mortgage backed securities are used as a refinancing tool by a range of financial services providers. They might be especially useful for mortgage lenders who are excluded from using of other refinancing tools such as deposits or covered bonds. Residential mortgage backed securities enable the division of the mortgage portfolio into tranches ranging from high rated AAA to unrated first loss and sell them to investors interested in certain asset classes. This allows mortgage lenders to offer a wide range of mortgage products to a wide range of different borrowers. Residential mortgage backed securities can also serve as a means to transfer credit and prepayment risk to third parties.

Only ten Member States (Belgium, France, Germany, Greece, Italy, Luxembourg, Malta, Poland, Portugal and Spain) currently have specific law on securitisation.[257] In other Member States, no specific securitisation law exists. In such cases, some specific provisions relating to securitisation may be found, notably in the tax and regulatory areas, creating a framework for securitisation operations.[258]

In Europe the issuance of residential mortgage backed securities has been the largest in the United Kingdom, which does not have a specific securitisation law, but accounts for 49% of residential mortgage backed securities issued in Europe.[259]

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[255] Cf. footnote 171, p. 47.

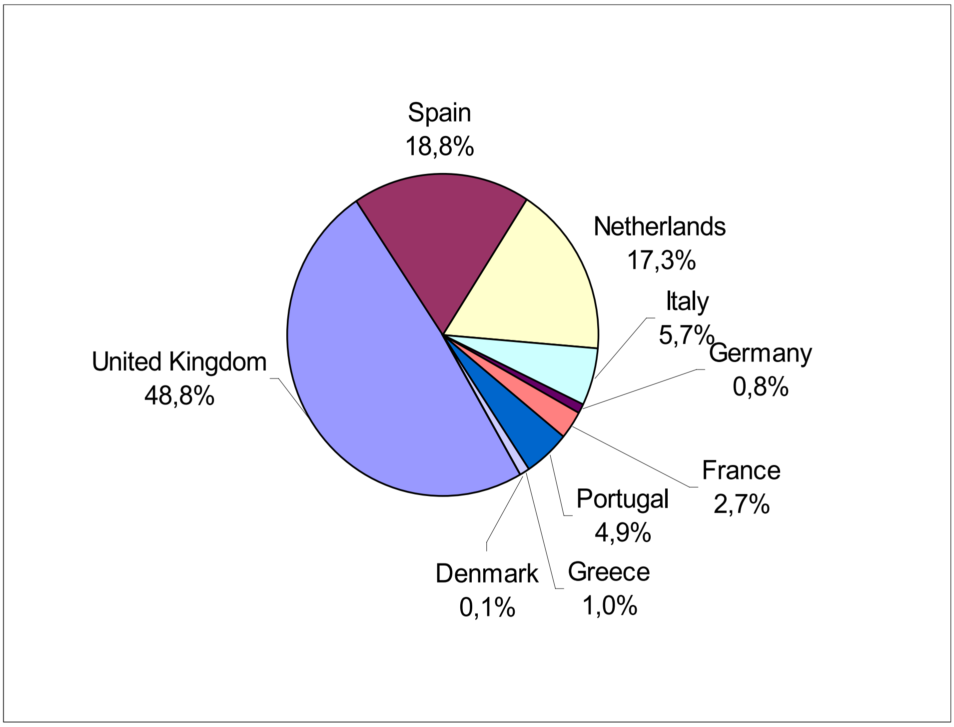
[256] *Legal Obstacles to cross-border securitisation in the EU*, European Financial Markets Lawyers Group, Working Group on Securitisation, 7.5.2007.

[257] Cf. footnote 171, p. 27.

[258] Cf. footnote 171, p. 27.

[259] Cf. footnote 171, p. 50.

Graph 13: European Residential Mortgage Backed Securities Issuance in 2005 by Country of Collateral



Source: *Report of the Mortgage Funding Expert Group*, 22.12.2006, p. 50. Based on data from JP Morgan Securities, Inc., Dealogic, Thomson Financial and Structured Finance International.

At the European level, legislation touches upon certain aspects of securitisation. For instance, the Capital Requirement Directive[260] sets out a harmonised set of rules for capital requirements for securitisation activities and investments, contains several definitions of securitisation related concepts such as originator, securitisation special purpose entity, tranche or credit enhancement and defines the minimum requirements respectively applicable for recognition of significant risk transfer. Other issues, such as the definition of the actual legal forms to which economic substance attaches, have not been addressed in the Capital Requirement Directive[261], leaving room for different interpretation to Member States.[262] The Prospectus Directive,[263] UCITS Directive and in the field of the Reinsurance Directive also consider certain aspects of securitisation.

10.2.2. Problem description

10.2.2.1.Diversity and fragmentation of national securitisation frameworks

In general, existing domestic legal frameworks appear to provide legal certainty and transparency of securitisation transactions at the national level.[264] Only in a few exceptional cases, does the domestic framework appear unsuited for the development of the national

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260 Directive 2006/48/EC, 14.6.2006.
261 Cf. footnote 260.
262 This problem is addressed in more detail in Section 10.6. (Basel II).
263 Directive 2003/71/EC, 4.11.2003.
264 Cf. footnote 256, p. 20.

securitisation market because, according to stakeholders, it has been enacted in reaction to a specific local industry or business need.[265]

However, although most of the existing domestic legal frameworks seem to be suited for the securitisation transactions on the national level, they have territorial constraints with regard to cross-border transactions because it is unclear whether provisions relating to taxation, bankruptcy remoteness or ring-fencing would also benefit foreign special purpose vehicles wishing to exercise their activity on the domestic territory and resulting in the risk of arriving at divergent solutions to identical transactions in different jurisdictions.[266] For instance, in the majority of Member States, no definition of securitisation is provided for. Even in those Member States, where the law provides a definition, the notion of securitisation varies considerably.[267] Consequently, differences exist in the securitisation techniques (traditional or synthetic) or the range of eligible assets used. Differences also exist in the types of vehicles available for securitisation in the different Member States,[268] on the requirements imposed on securitisation vehicles[269], their bankruptcy remoteness[270] and whether banking laws apply to securitisation special purpose vehicles and their activities.[271] To overcome the differences in the national securitisation laws, many of the multi-jurisdiction transactions so far have required the establishment of intermediary special purpose vehicles in those jurisdictions where pools of assets were located in order to achieve legal certainty for the transfer of assets under the local securitisation or civil law.[272] The requirement to set up an intermediary special purpose vehicle increases the cost of securitisation as well as the complexity of the transactions. The higher refinancing costs for mortgage lenders may then be translated into higher borrowing costs for consumers. In addition, taking into account that securitisation transactions are per se a complex refinancing tool, the complexity of transactions may reach a level where it is unusable by the majority of mortgage lenders.

Another obstacle for mortgage lenders that seek to use securitisation as an alternative funding technique in cross-border transactions are specific requirements with respect to the status of the party who intends to sell and securitise a portfolio of assts (so called originator[273]). For instance, in Greece an originator must be a business undertaking registered in the country or at least have an establishment in Greece.[274] The requirement would mean that mortgage lenders not registered or having an establishment in Greece are excluded from selling their

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265 For instance, the Investment Funds Act of 27.5.2004 in Poland has resulted in mostly only non-performing loans being securitised in the Polish market. See footnote 171, p. 28.

266 For instance, in Luxembourg, the securitisation law applies only to securitisation undertakings situated in Luxembourg. See footnote 256, pp. 62–63.

267 Cf. footnote 256, p. 21.

268 There are typically two main legal forms used for securitisation vehicles: Special Purpose Vehicles set up as a company with a legal personality and those set up as a fund without legal personality. For examples, in which Member States both or one of these legal forms are recognised see footnote 256, p. 88.

269 E.g. in case of securitisation funds, management companies must usually obtain a license from their respective domestic supervisory authority and are subject to specific regulatory requirements, e.g. a requirement to establish or have the registered office in the jurisdiction concerned, see footnote 256, p. 28.

270 Cf. footnote 256, p. 40.

271 E.g. in France, the activity of acquiring receivables on a regular basis can be considered a credit operation. Foreign securitisation vehicles might therefore need a banking license in order to operate under French law. See footenote 256, p. 26.

272 Cf. footnote 171, p. 31.

273 *A Framework for European Securitisation*, European Securitisation Forum, May 2002, p. 11.

274 Cf. footnote 256, p. 30.

assets to a special purpose vehicle under the Greek securitisation law, therefore requiring such mortgage lenders to use other, potentially more expensive or complex refinancing instruments including securitisation under another national law. Higher costs for refinancing are likely to translate into higher cost for borrowing for consumers. Furthermore, some foreign mortgage lenders might refrain from offering their products to Greek consumers if they need to establish the securitisation transaction under another law than the Greek one due to possible legal uncertainties for the transfer of assets to the special purpose vehicle (see above). The requirement with regard to the status of the originator therefore imposes a certain barrier for foreign mortgage lenders without an establishment in Greece. This impacts therefore on the level of competition in markets with such limitations and the range of available products.

Legal uncertainties also exist with regard to the segregation techniques used in the different jurisdictions,[275] with regard to the debtor's consent or notification of the debtor when transferring the assets[276] and with regard to the automatic transfer of ancillary rights (such as securities on immovable property) attached to the assets.[277]

As a consequence, existing national securitisation legislation impede to a certain extent the development of a deep pan-European mortgage-backed securitisation market by imposing a range of requirements on mortgage lenders that seek to use cross-border securitisation as refinancing tool. This might deter mortgage lenders from engaging in cross-border lending because of the additional costs arising from the legal uncertainty with regard to multi-jurisdiction securitisation transactions might outweigh the economic benefit from engaging in cross-border lending business. As a result, competition in any given market may be below its potential and consumers might face a smaller range of products. However, while the existing national securitisation legislation impose problems for the development of a deep pan-European mortgage-backed securitisation market, further research would need to be undertaken to evaluate more concretely to what extent these problems actually impede the market.

10.2.2.2. Limits for UCITS with regard to investments in residential mortgage backed securities of single residential mortgage backed securities issuer (Article 22 of UCITS Directive)[278]

Some stakeholders pointed out that the limitations imposed for undertakings for collective investment in transferable securities (UCITS) by Article 22(1) of the UCITS Directive with regard to investment in AAA rated residential mortgage backed securities of a single residential mortgage backed securities issuer would limit investor flexibility with respect to residential mortgage backed securities.[279] Article 22(1) of the UCITS Directive foresees that a UCITS may invest no more than 5% of its assets in transferable securities or money market instruments issued by the same body. However, pursuant to Article 22(2) of the UCITS Directive, Member States may derogate from the investment limit of 5% and allow UCITS to invest up to 10% of their assets into financial instruments of a single issuer (including residential mortgage backed securities). A higher threshold for UCITS could potentially

275 In most jurisdictions, it is not possible to segregate assets on the originator's balance sheet without transferring the assets. See footnote 256, p. 33.

276 This issue is addressed in more detail in Section 10.3. (Transferability of mortgage loan portfolios to third parties).

277 See for example, footnote 256, p. 33.

278 Directive 85/611/EEC, 20.12.1985.

279 Cf. footnote 171, p. 31.

increase the demand for residential mortgage backed securities, making it easier and cheaper for the mortgage lender to refinance their mortgage pools using residential mortgage backed securities. This could in turn benefit consumers through lower prices and a potentially wider choice of products.

However, while the investment limit of 5% and 10% respectively have been presented by certain stakeholders as a problem, no compelling evidence, for instance referring to market figures, has been produced by stakeholders that the current investment limits for UCITS to invest in residential mortgage backed securities of a single residential mortgage backed securities issuer are insufficient. In addition, no evidence has been produced why residential mortgage backed securities should be treated in the same way as bonds issued by credit institutions having their registered office in a Member State and being subject to public supervision pursuant to Article 22(4) of the UCITS Directive. Unlike the aforementioned bonds, residential mortgage backed securities are not issued by credit institutions, but by or on behalf of special purpose vehicles that are not subject to public supervision and that may have their registered office outside the European Union. The capitalisation of such special purpose vehicles is generally very low. In case of financial difficulties, shareholders (such as credit institutions) are not obliged to support the special purpose vehicles. The current difficulties of special purpose vehicles in the US housing debt market rather demonstrate that the issuer risk of special purpose vehicles is not comparable with the issuer risk of credit institutions having their registered office in a Member State and being subject to public supervision.

Table 56: Problems and consequences

Problem	Consequences
Residential mortgage backed securities frameworks: ▪ Diversity and fragmentation of national securitisation frameworks ▪ Limits for UCITS with regard to investments in residential mortgage backed securities of single residential mortgage backed securities issuer (Article 22 of UCITS Directive)	For mortgage lenders: – Inability to create multi-jurisdiction securitisation transactions – Increased refinancing costs – limited scope for economies of scale => Mortgage lenders may be deterred from cross-border activity => Reduced competition => Reduced product diversity For consumers: – Limited product choice – Higher prices For investors: – Lack of transparency – Restricted investment opportunities => Reduced demand

10.2.3. Objectives

The Commission aims at:

- facilitating the development of a wide range of mortgage funding instruments by removing the barriers to the use of domestic and cross-border securitisation by mortgage lenders; and
- ensuring that investors in residential mortgage backed securities do not face unnecessary limitations without compromising investor protection.

10.2.4. Description of options

10.2.4.1. Option 1: Further research on the fragmentation of EU securitisation framework

A range of different policy options, such as a recommendation setting out certain principles that Member States should take into account in their securitisation laws, a Directive on securitisation, or the development of an optional European regime, could eventually be considered to address the issue of the different and fragmented national securitisation frameworks.

However, before the impact of different policy options to address the fragmentation of European securitisation framework can be evaluated with the necessary thoroughness, further research needs to be undertaken to assess the exact nature and magnitude of the problem.

10.2.4.2. Option 2: Do nothing

Regarding the current investment limits of 5% and 10% respectively for UCITS to invest in residential mortgage backed securities of a single issuer, no compelling evidence that these are insufficient has been produced by stakeholders. Even if investor appetite in this respect had been proven, the potential advantages of a higher investment limit would have to be balanced against the increased risks for UCITS investors. The current investment limit significantly reduces the issuer risk which UCITS are subject to. This is a key element to protect UCITS investors. The proposal thus implies a deviation from fundamental safeguards for UCITS. The fact that only AAA rated residential mortgage backed securities shall benefit from an increased investment limit does not address the issuer risk. Unlike bonds issued by credit institutions having their registered office in a Member State and being subject to public supervision, residential mortgage backed securities are not issued by credit institutions, but by or on behalf of SPVs that are not subject to public supervision and that may have their registered office outside the European Union. The capitalisation of such special purpose vehicles is generally very low. In case of financial difficulties shareholders are not obliged to support the special purpose vehicles. The current difficulties of special purpose vehicles in the US housing debt market rather demonstrate that the issuer risk of special purpose vehicles is not comparable with the issuer risk of credit institutions having their registered office in a Member State and being subject to public supervision. Therefore, no deviation from the current thresholds for the exposure to issuer risk which is one of the fundamental safeguards for UCITS is justified. Furthermore, the approach to privilege residential mortgage backed securities over other forms of asset backed securities is as such questionable, as the issuer risk a UCITS has to bear is not directly linked to the underlying asset. Also for legal reasons the issuers of residential mortgage backed securities should not be treated better than the issuers of other types of asset backed securities, given that all forms of securitisation may under certain market conditions reduce refinancing costs.

In conclusion, this option would not have any impact on stakeholders as it would not change the current situation.

Table 57: Overview of impacts

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Do nothing	Consumers (I)	≈	n.a.	n.a.	Certain
	Mortgage lenders issuing residential mortgage backed securities (D)	≈	n.a.	n.a.	Certain
	Investors (UCITS) (D)	≈	n.a.	n.a.	Certain
	Member States (D)	≈	n.a.	n.a.	Certain

Table 58: Overview of policy option effectiveness

Option	**Specific**	**General**				**Comments**
	Ensure the acceptance of mortgages on non-domestic property as cover assets	**Product diversity**	**Consumer confidence**	**Consumer mobility**	**Cross-border activity**	
Option 1: Do nothing	≈	≈	≈	≈	≈	

Assessment: ++ = strongly positive; + = positive; – – = strongly negative; – = negative; ≈ = neutral/marginal; ? = uncertain

10.3. Transferability of mortgage loan portfolios to third parties

10.3.1. Context

A mortgage lender may sell and transfer a mortgage loan portfolio to third parties for several reasons. A mortgage lender could sell a loan portfolio for refinancing purposes to a third party through, for example, a whole loan sale[280] or a true sale (traditional) securitisation transaction[281]. In addition, the sale could be used by the mortgage lender for equity optimisation purposes, risk management, diversification of assets or for detachment of non-core business.

280 A whole loan sale refers to the sale of a mortgage loan or a pool of loans in unsecuritised form. For more information on how a whole loan sale works, see footnote 171, p. 56.

281 'Traditional securitisation' means a securitisation involving the economic transfer of the exposures being securitised to a securitisation special purpose entity which issues securities. This shall be accomplished by the transfer of ownership of the securitised exposures from the originator credit institution or through sub-participation. The securities issued do not represent payment obligations of the originator credit institution.' Article 4(37) of Directive 2006/48/EC, 14.6.2006.

The transfer of a loan portfolio to third parties provides several advantages for mortgage lenders in terms of refinancing. First, it can be used by mortgage lenders as a complementary source of funding, enabling mortgage lenders who are unwilling or unable to engage in securitisation or covered bond transactions to engage in mortgage lending without the need to draw on deposits.[282] Second, for some mortgage lenders, the sale of mortgage portfolios may in fact represent the only refinancing option, for instance, in order to collect deposits, the mortgage lender must be a credit institution[283]; in many Member States, a license is required to be able to issue covered bonds[284]. Third, many mortgage lenders may use the ability to buy and sell mortgage credit portfolios as a tool to improve the structure of their loan portfolios in terms of geographical concentration or portfolio diversification. Fourth, some mortgage lenders may want to buy mortgage credit portfolios to reach a critical mass for accessing the capital funding markets[285]. Finally, in context of a true sale securitisation transaction, the sale of a mortgage loan portfolio to a Special Purpose Vehicle (SPV) is a necessary step within the transaction.[286]

Ensuring direct and indirect access to capital markets through the sale of mortgage portfolios could reduce the costs for funding which is ultimately for the benefit of private borrowers. It could also contribute to product diversity because mortgage lenders which are able to package and sell mortgage loan portfolios to third parties could optimise their funding strategies and offer a wider range of mortgage products to consumers compared to those using one single type of refinancing instrument or certain types of refinancing instruments which might impose certain requirements on the range of assets that are eligible for refinancing (e.g. securitisation or covered bonds).

10.3.2. Problem description

A mortgage loan portfolio could consist of several hundred residential mortgage loans. In a true sale or whole loan sale, all those loans are transferred to the buyer of the portfolio as the new beneficiary. The transfer of a mortgage loan portfolio can be divided into two parts: the assignment of the claim and the fate of the collateral.

10.3.2.1. Need for the consent or notification of the borrower for the assignment of the claim

When undertaking the transfer of a mortgage portfolio from a mortgage lender to a third party, it is important that the different loan claims can be assigned.[287]

In the majority of Member States it is, in principle, possible to assign the mortgage loan to a third party, unless the loan contract between the borrower and the mortgage lender provides otherwise.[288]

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282 For instance, the costs for setting up a securitisation structure might be prohibitive, in particular for smaller lenders. Moreover, in order to get a high covered bond rating, a high quality and diverse pool of cover assets is required, which may be difficult for certain institutions.

283 Article 4(1) of Directive 2006/48/EC, 14.6.2006.

284 For further reference see Section 10.1. (Covered bonds).

285 Regular issuance of securities ensures name recognition of the issuer which may result in lower funding costs.

286 As opposed to a synthetic Residential Mortgage Backed Securitisation, where the loans are not removed from the balance sheet of the original lender. For a definition of synthetic securitisation see Article 4(38) of Directive 2006/48/EC, 14.6.2006.

287 Requirements regarding the consent of the borrower for the transfer of personal data from the lender to a third party are dealt with in Section 10.5. (Data protection).

During the consultation process, some stakeholders pointed out that even if the loan contract between the borrower and the mortgage lender does not exclude the assignment of the claim to other parties, the consent of the borrower might nevertheless be needed for the assignment to be valid. Against this background, stakeholders were concerned that a potentially required explicit consent of the borrower could expose the transaction parties to unnecessary administrative burdens and uncertainty with respect to the size and timing of the transaction, for instance when borrowers are not willing to offer their consent or may not reply in due time.[289] This could indeed constitute a considerable burden in terms of cost and effort for the transfer of portfolios consisting of several hundred mortgage loans and could therefore be a problem for the transfer of portfolios.

The Commission has sought to identify those Member States where explicit consent or other formalities are required for the assignment to be effective. The Commission could, based on the information currently available, only identify very few jurisdictions where the explicit consent of the borrower would be needed for the assignment of a mortgage claim to a third party. In addition, the identified requirements for consent seem to be the exception than the rule. For instance, in Sweden, consent is not required unless the agreement between the borrower and the mortgage lender requires such consent.[290] Therefore, based on the information currently available, explicit borrower's consent appears not to be a problem for mortgage lenders when transferring mortgage loan portfolios.

Regarding other formalities for the effectiveness of the assignment, in some jurisdictions, such as Denmark, Finland, Greece and Sweden, notification of the borrower is mandatory for the assignment to be effective.[291] Notification might be required in other Member States for the assignment to become enforceable against third parties or to ensure that the debtor loses his right to discharge his obligation with the assignor. When notification is not required for effectiveness of the assignment, consumers may not even be aware of any change in the relationship as the original mortgage lenders may maintain the servicing of the loans, e.g. by collecting the payments and forwarding it then to the new creditor.

The requirement for notification in some countries exposes the buyer and seller of the mortgage portfolio to administrative burden.[292] Any additional costs impact on the economic rationale for using a portfolio sale as a refinancing tool. As said before, if mortgage lenders cannot get the refinancing for certain products, product diversity for consumers might be impaired. There is also the risk of deterioration of the borrower-lender relationship from informing a borrower that his mortgage loan has been transferred, e.g. borrower loyalty might

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288 In Austria, an agreement between the creditor and the debtor prohibiting the transfer of a loan does however, according to some sources, (see footnote 256, p. 39) not affect the effectiveness of the assignment. In Germany, it has been discussed for some time whether banking secrecy or data protection rules may result in a tacit agreement between lender and borrower not to assign the loan to third parties. This was however denied by the German Federal Court in a recent decision (BGH, 27.2.2007, XI ZR 195/05).

289 Cf. footnote 171, p. 19.

290 Cf. footnote 256, p. 37. Furthermore, for instance in Germany, other legal methods than assignment can be used in order transfer claims such as a tripartite agreement to replace the creditor. For this type of agreement consent of the borrower is required.

291 Cf. footnote 256, p. 38. In Greece, however, a notification is considered to have taken place upon registration of the securitisation agreement in the public register.

292 According to the information provided to the Commission, in some countries collective notification systems, such as the announcement of the portfolio transfer in a publicly accessible communication medium, have been introduced to keep the costs for notification as low as possible.

be reduced. However, at the same time it has to be taken into account that formalities for the effectiveness of the assignment, such as the notification of the borrower might be justified. Borrowers have a strong interest in being notified in case of assignment of the claim to third parties in order to keep informed about their present creditors. For instance, a new creditor might launch legal proceedings to foreclose the mortgage property as soon as a consumer fails to meet the conditions set out in the mortgage contract without looking for alternative ways to help the consumer first. This impacts therefore on consumer confidence.

While the notification of the borrower as such might therefore be justified from the point of the consumer, the interests of the mortgage lenders could be impaired when the costs associated with the notification are unjustifiably high. However, no evidence has been presented so far regarding the materiality of these costs.

10.3.2.2.Registration requirement for changes to the beneficiary of the collateral

If a mortgage lender transfers the loan claims to a third party, it needs to be examined what happens to the collateral.

Collateral exists in a non-accessory[293] and in an accessory form[294] in the different Member States. Accessory collateral can generally not be separated from the underlying claim because there is a statutory connection between the security and the claim. Its fate is dependent on the fate of the secured claim. This means that if a secured claim is transferred to a new creditor, accessory collateral is automatically transferred as well, because the holder of the secured claim and the holder of the collateral must be the same person. This automatism results in a registration process, where registration is constitutive for the validity of the mortgage deed.[295]

In Member States, where registration is constitutive, any changes to the beneficiary of the collateral would have to be registered in the land register. This requirement exposes the mortgage lender to considerable costs in form of registration fees, notary costs and taxes.[296] The registration cost adds to the overall costs of a portfolio transfer thereby increasing the funding costs for the mortgage lender. The high costs connected with the transfer impair the usability of portfolio transfer to third parties as a refinancing tool. However, when looking at

293 Non-accessory collateral exist for instance in Denmark, Estonia, Germany, Hungary and Slovenia. 'EU enlargement in Eastern Europe and dogmatic property law questions – Causality, Accessoriness and Security Purpose', O. Soergel / O. Stöcker, *Notarius International*, Vol. 7, 3–4/2002, p. 241.

294 There are different degrees of accessoriness across Europe. Legal systems with collateral that is closely accessory exist for instance in Belgium, Italy, Luxembourg, Poland and Spain. In between closely accessory and non-accessory collateral exist legal systems that have either a special legal form with a relaxed accessoriness, such as the Netherlands and Austria, or have developed a form of a collateral through lending practises which comes close to being a non-accessory collateral, such as England and Wales and Sweden. 'EU enlargement in Eastern Europe and dogmatic property law questions – Causality, Accessoriness and Security Purpose', O. Soergel / O. Stöcker, *Notarius International*, Vol. 7, 3–4/2002, p. 241.

295 As outlined before (see Section 7. (land registers)), some collateral become effective only upon registration in a public register (constitutive registration). This is, for instance, the predominant principle in Germany, Austria and Hungary. Others are capable of being registered on request but may still be valid even if not registered (declaratory registration). For instance, in Poland the principle of declaratory registration is predominant. Any change in the legal situation is not effected by registration. See *Flexibilität der Grundpfandrechte in Europa*, O. Stöcker, Vol. 1, 2006.

296 See Section 7. (land registers) for further information on the different costs connected with the collateral registration process.

the requirement of registration, other stakeholders, such as the borrower, the borrower's creditors and the creditors of the third party, have a strong interest that the land register discloses the identity of the current holder of the collateral, therefore ensuring consistency between legal reality and the land register.[297]

This costly registration process could in principle be avoided in those countries where non-accessory collateral exists,[298] which can be separated from the underlying claim. In those countries, the selling mortgage lender and the buying third party can in principle agree in a fiduciary agreement that the non-accessory collateral is held in trust for the third party without transferring the legal title to the third party. While non-accessory collateral appear to offer advantages with respect to their required transfer, questions might remain in some jurisdictions as to what happens with the collateral in case of insolvency of the mortgage lender and whether the third party has a claim for segregation with regard to the collateral.

In some Member States, solutions have been developed to avoid the costly registration process and to facilitate the transfer of loan portfolios. For instance, in Germany, the Law on the creation of refinancing registers[299] introduced a new legal instrument, i.e. the refinancing trust, enabling refinancing enterprises to segregate sold assets without transferring the title simply by registration in a refinancing register. Another example is the 'participaciones hipotecarias' in Spain which are used for Spanish mortgage backed securitisation transactions. Under this construction, while the mortgage loans including their collateral remain on the balance sheet of the mortgage lender, only the so called 'participaciones hipotecarias', which each represents a percentage on each mortgage loan, are transferred to third parties.[300] This construction saves the costs connected with a cession of mortgage loans.[301]

However, even if the different solutions may be suitable to solve the registration requirement and therefore also the cost problem in connection with the registration process on a national basis, it is unclear to which extent those solutions are applicable to portfolios consisting of mortgage loans from different Member States. To avoid legal uncertainty, mortgage lenders might only package assets from one jurisdiction together in a portfolio. This might increase the cost for funding and therefore for the mortgage loan. In addition, not all Member States may have developed such solutions facilitating the transfer of mortgage portfolios. The cost problem connected with the change of the beneficiary of the collateral in case of a transfer of a mortgage portfolio has therefore not been solved yet on a cross-border level and in certain national jurisdictions. As said before, this will impair the use of a portfolio sale as a refinancing tool, leading to restrictions in the range of products that can be offered to consumers.

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297 See, for instance, *Note on the Report on the mortgage funding expert group in connection with the questions referring to property registration*, European Land Registry Association, http://ec.europa.eu/internal_market/finservices-retail/docs/home-loans/mort_comments/repr-eu_elra-en.pdf.

298 For instance, in Denmark, Estonia, Germany, Hungary and Slovenia.

299 Entered into force in 2005. See for more information on details of the Act, footnote 256, p. 36, and *Die Bedeutung des neuen Refinanzierungsregisters für Asset Backed Securities*, C. Tollmann, ZHR, 169 (2005) 594f.

300 *Securitisation & Mortgage Bonds*, S. Nasarre-Aznar, 2004, p. 61.

301 For instance, the cost for a mortgage loan cession of 22956 securitised mortgage loans (EUR 600 million issue) in Spain would be around EUR 6.89 million. See footnote 300, p. 73.

Table 59: Problems and consequences

Problem	Consequences
Barriers to the transferability of mortgage loan portfolios: ▪ The need for notification of the borrower for the effectiveness of the assignment of the claim ▪ Registration requirement for changes to the beneficiary of the collateral	For mortgage lenders: – Higher refinancing costs => reduced scope for economies of scale – Inability to access refinancing for certain products => Mortgage lenders may be deterred from cross-border activity => Reduced competition => Reduced product diversity For consumers: – Limited consumer choice – Higher prices For investors: – Higher costs connected with the purchase of mortgage loan portfolios and its underlying securities => Reduced demand

10.3.3. Objectives

The Commission aims to:

- facilitate the transfer of mortgage loan portfolios without compromising on necessary consumer protection rules and without questioning existing national collateral forms where registration required; and to
- remove unnecessary costs for the transfer of mortgage loan portfolios.

10.3.4. Description of options

A range of possibly policy options could be considered to address the objective of the Commission to facilitate the transfer of mortgage loan portfolios and to remove unnecessary costs. For instance, it could be considered to issue a recommendation to Member States (to review the existing formalities for the transfer of mortgage loan portfolios and to consider the introduction of collateral instruments which are more flexible in terms of usability and transferability), to issue legislation or to create an 'Eurohypothec'[302] as an alternative instrument for securing loans on property to existing national concepts of collateral.

However, before any of these policy options can be evaluated with the necessary thoroughness, further research needs to be undertaken to assess the exact nature and magnitude of the identified problems.

10.3.5. Option 1: Further research

As described before, it is currently not clear to what extent a notification of borrower hinders the transfer of mortgage loan portfolios. Against this background, it is therefore currently not possible to establish whether the benefits of any changes with regard to the required notification would outweigh the costs, especially for consumers, connected with such a change. Further study of the benefits and costs of removing notification would be required.

With regard to the registration requirement for changes to the beneficiary of the collateral, it needs to be established what kind of solutions have been developed on the national level to address and to circumvent this issue, to which extent those solutions are applicable to portfolios consisting of mortgage loans from different Member States and whether those solutions are compatible with the interests of other stakeholders, such as borrowers.

10.4. Reporting

10.4.1. Context

The availability of data on financial instruments when they are the subject of a public offer or an application for admission to trading is primarily provided in the prospectus or Offering Circular. Where the instruments in question are 'transferable securities'[303] the prospectus must be drawn up and published in accordance with detailed requirements under the Prospectus Directive, which provides a regulatory framework for such information.[304]

Certain information requirements are imposed at the European level by the Markets in Financial Instruments Directive (MiFID)[305] for investment firms providing investment services to clients in order to enable them to take their investment decision on an informed basis.[306] The MiFID information requirements principally refer to the moment when the investor is taking his decision (the so-called 'point of sale') and in the main do not constitute on-going reporting requirements during the life of the security. Periodic reporting

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302 The 'Eurohypothec' or 'Euromortgage' would be structured as a non-accessory real estate collateral instrument. For more information on this instrument see *Basic Guidelines for a Eurohypothec*, A. Drewicz-Tułodziecka, May 2005.

303 As defined in Article 4(1) of Directive 2004/39/EC (the Markets in Financial Directive – 'MiFID'), 21.4.2007.

304 Directive 2003/71/EC, 4.11.2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC. The detailed contents requirements for a prospectus are set out in implementing measures in Regulation (EC) No 809/2004, 29.4.2004.

305 Principally, Articles 19(3) and (8) of Directive 2004/39/EC, 21.4.2004 amending Directives 85/611/EEC, 93/6/EEC and Directive 2000/12/EC and repealing Directive 93/22/EEC.

306 Based on the requirement by Article 65(1) of MiFID, the Commission is currently engaged in an extensive review as to what extent new requirements on pre- and post-trade transparency should be introduced at EU level to the trading in financial instruments such as bonds and other non-equities. For more information see http://ec.europa.eu/internal_market/securities/isd/mifid_reports_en.htm.

requirements are imposed by MiFID[307] on investment firms which provide the service of portfolio management to clients. For other services, the Directive[308] imposes a requirement to provide the client with 'adequate reports on the service provided' but does not specify in detail what these must contain or their periodicity. The Market Abuse Directive[309] imposes information requirements with regard to information that, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments. In the case of transferable securities that are traded on a regulated market, the Transparency Directive[310] also requires issuers to disclose to the markets annual and half-yearly financial reports and management statements.

National legal frameworks, for instance on securitisation or covered bonds, also contain certain ex post issuance reporting requirements on a regular basis during the life of the security in order to increase transparency for investors. For instance, for covered bonds ('Pfandbriefe') in Germany, banks licensed to issue 'Pfandbriefe' are required to publish on a quarterly basis in a publicly accessible form a range of information on the issued Pfandbriefe, such as the type of cover assets, the number of payments in arrears, etc.[311] This information is given on an aggregated pool basis.

In addition, initiatives by the market have been undertaken to improve the quality, uniformity and availability of pre- and post-issuance information on residential mortgage backed securities. In May 2006, for instance, the European Securitisation Forum published the 'Securitisation Market Practice Guidelines'.[312]

10.4.2. Problem description

10.4.2.1. Different levels of reporting across the EU

Information on the different capital market products is fundamental for investors in capital market products such as residential mortgage backed securities or covered bonds because it enables investors to assess the risk connected with such products. In situations with scarce or unreliable information, investors are unable to properly assess the risks. This is highlighted for instance by the current sub-prime mortgage crisis in the United States, where investors in Collateralized Debt Obligations[313], which are backed by sub-prime mortgage loans, have not been able to fully assess and to understand the risks connected with those instruments.[314] As a consequence, investors were hit by the massive credit defaults and were forced to adjust the value of their investments considerably.

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[307] Article 41 of Directive 2006/73/EC, 10.8.2006 implementing Directive 2004/39/EC, 21.4.2004.

[308] Article 19(8) of Directive 2004/39/EC, 21.4.2004.

[309] Directive 2003/6/EC, 28.1.2003.

[310] Directive 2004/109/EC, 15.12.2004 amending Directive 2001/34/EC, 28.5.2001.

[311] Article 28 of the German Pfandbrief Act (Pfandbriefgesetz), 22.5.2005.

[312] In total, 86 different fields and relative definitions have been identified by the market as most relevant for Residential Mortgage Backed Securities investment decisions. These currently cover security level data regarding the notes being issued, collateral level data regarding the aggregate pool characteristics, stratified aggregate loan level data and contact level information. In the future, this could include loan-by-loan data. For more information, see http://www.europeansecuritisation.com/pubs/FinalESFGuidelines16May06.pdf.

[313] Collateralized Debt Obligations are essentially asset backed securities. A portfolio of bonds, loans, or other fixed income securities is assembled and used to create a new set of fixed income securities.

[314] 'Does it all add up?', S. Scholtes / G. Tett, *Financial Times*, 28.6.2007.

As mortgage funding markets have developed on a piecemeal basis across Europe, the extent to which information on the different capital market products is available to investors and is comparable can vary significantly.[315] The different levels of information disclosed to investors, both prior and post issuance, on collateral pools, residential mortgage backed securities tranches, and to some extent, covered bond pools have been identified by stakeholders as an obstacle to transparency.[316]

With regard to the information provided to investors prior to issuance, the Prospectus Directive sets out a certain framework for the provision of general information and certain specific reporting requirements on the underlying assets of asset backed securities prior to issuance.[317] The Directive does not contain such specific reporting requirements with regard to the underlying asset on covered bonds.[318] In addition, the Directive is designed to protect investors according to their level of expertise. According to this objective, a prospectus is not required for offers limited to qualified investors such as credit institutions, investment firms, insurance companies and other authorised or regulated financial institutions. Those are however the typical investors in capital market funding products such as residential mortgage backed securities or covered bonds as those securities are often sold in private placements.[319]

Information requirements for post issuance might even vary within one jurisdiction if no information requirements have been set by national law.

According to the information currently provided to the Commission, with regard to residential mortgage backed securities, it is difficult to gather price information regularly on a large number of European residential mortgage backed securities both at the time of creation of the security (transaction reference data) and during the life of the security (dynamic reference data).[320]

With regard to covered bonds, stakeholders identified the following areas in which market information for covered bonds could be enhanced: market rules and regulations; product information and characteristics; mortgage pool information and reporting; portfolio granularity; risk management; composition and behaviour; market risks (interest rate risk, prepayment risks, etc); and risk weightings assigned by supervisory authorities.[321]

Without being able to properly assess the risks connected with certain investments, investors would demand a risk premium from the mortgage lender issuing the product to compensate for the potential unknown risk factor connected with the financial instrument. The availability of information to investors therefore contributes to the determination of a mortgage lender's

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315 The level of information provided to third parties such as investors might also vary due to restrictions for data protection reasons. Data protection is dealt with in more detail in Section 10.5.

316 Cf. footnote 171, p. 36.

317 See Annex VIII of the Commission Regulation (EC) No 809/2004, 29.4.2004 implementing Directive 2003/71/EC, 4.11.2003.

318 Annex VIII does not apply to covered bonds. See Recital 13 of the Commission Regulation (EC) No 809/2004, 29.4.2004 implementing Directive 2003/71/EC, 4.11.2003.

319 For instance, collateralised debt obligations backed by subprime mortgages are rarely traded but created by bankers directly with investors and then left to sit on the books of investors. See footnote 314.

320 Cf. footnote 171, p. 36.

321 Cf. footnote 171, p. 36.

refinancing costs. Some investors might even decide against participating in certain funding markets due to the lack of information transparency regarding certain financial instruments.[322]

This has knock-on indirect effects on consumers. A lack of price transparency for certain financial instruments and the subsequent higher refinancing costs or – at worst – the inability to find investors for certain financial instruments could result in higher prices being offered to consumers or even mortgage lenders deciding against offering certain products. The chance of this is particularly high for the high-risk mortgage loan segment where information for investors is even more important to assess their investment risk.

10.4.2.2.Lack of consistency in definitions across the EU[323]

Even when the same level of information is provided to investors, issuers may have different definitions of the default, delinquency or recovery rates as well as LTV ratios.[324] A lack of standard definitions can sometimes result in information which may initially seem comparable actually being quite different. For instance, the different definitions of loan-to-value ratios in different jurisdictions might lead to – all factors being equal – different values for such an important factor for investors. Even worse, the same number for a loan-to-value ratio might represent completely different values in different jurisdictions. Consequently, the lack of clear definitions makes it difficult to compare transaction performance and hence to calculate prices. This is true not only for issuers in different countries, but can also occur between issuers in the same country if definitions have not been standardised in the national framework.

In addition, the disparity of definitions across the EU makes it difficult, costly and time-consuming to assemble a multi-jurisdictional portfolio of loans with similar financial profile and characteristics. For example, if the loans included in a portfolio have originated in different jurisdictions, investors cannot be sure if the risk profiles and the characteristics of the included loans are truly comparable to each other. An investor might therefore demand a risk premium based on the more risky loans included in the portfolio rather than on the best credit.

The lack of consistency in definitions across jurisdictions may therefore lead to an increase in funding costs in markets and lower product diversity due to lower investor interest in the securities or due to the demand for higher risk premiums.

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322 Cf. footnote 171, p. 35.

323 The lack of standard definitions is also relevant with regard to databases which are accessed by mortgage lender in order to get information about the credit worthiness of a potential consumer. Different notions might however exist with regard to the available information, for instance, regarding the definition of borrower default. See Section 4. (Credit registers) for further information.

324 Cf. footnote 171, p. 35.

Table 60: Problems and consequences

Problem	Consequences
Reporting: ▪ Different levels of reporting across the EU ▪ Lack of consistency in definitions across the EU	For mortgage lenders: – Higher refinancing costs => reduced scope for economies of scale – Inability to access refinancing for certain products => Mortgage lenders may be deterred from cross-border activity => Reduced competition => Reduced product diversity For consumers: – Limited product choice – Higher prices For investors: – Lack of transparency – Inability to accurately identify appropriate products => Reduced demand

10.4.3. Objectives

The Commission aims to improve:

- market transparency by promoting the development of reporting standards without compromising data protection;
- the comparability of mortgage funding instruments by developing standardised definitions for capital market mortgage funding products.

10.4.4. Description of options

10.4.4.1. Option 1: Do nothing

Doing nothing would mean that in principle the problems identified remain and the lack of transparency for investors would continue to exist. Certain initiatives with the view to increasing transparency for investors would be undertaken by the market itself, such as the ongoing establishment of reporting standards for residential mortgage backed securities by the European Securitisation Forum.

10.4.4.2.Option 2: Self-regulation

The issues of different levels of reporting and differences in definitions across the EU could be dealt with by market practitioners by means of self-regulation. Market practitioners could be encouraged to develop reporting standards prior and post issuance for capital market funding products and a standard for key terms used in secondary markets. Industry could adopt a Code of Conduct to ensure the application of the developed reporting and definition standards.

As described above, similar market based initiatives, such as that led by the European Securitisation Forum, have already been undertaken. Such market initiatives could culminate in one or more (according to the different funding market instruments) Codes of Conduct to be signed by market participants. The Commission could review the success of any Codes of Conduct after a certain time period.

10.4.4.3.Option 3: Legislation

The Commission could consider adopting legislation on reporting standards for capital market mortgage funding products including a standardisation of certain definitions.

10.4.5. Impact assessment

10.4.5.1.Option 1: Do nothing

Doing nothing would only partly solve the problems described above.

On the one hand, as outlined above (see Section 10.4.1.), the European Securitisation Forum has already developed reporting standards for residential mortgage backed securities. Should these standards be adopted by securitisation market participants, they could in principle help to improve market transparency by standardising reporting requirements and definitions across Europe for residential mortgage backed securities. Investors would be able to assess the risks connected with securitised mortgage loans in more detail and would be able to demand risk-appropriate premiums from mortgage lenders. Mortgage lenders using securitisation as a refinancing instrument would face one-time costs for establishing reporting procedures. They would also face additional ongoing reporting costs. However, those costs could be offset – at least to some extent – by lower funding costs. Consumers could indirectly benefit from lower prices and possibly a wider range of mortgage products. There would be no additional costs for Member States arising from this option.

On the other hand, without any action by the Commission, the incomparability of different mortgage backed financial instruments would persist for other capital market mortgage funding products. Investors would be unable to accurately assess the risks of certain mortgage funding instruments, leading to a risk of mis-pricing.

Table 61: Impacts of Option 1

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Do nothing	Consumers (I)	+ ↑ product diversity (I) + ↓ prices (I)	Medium to long term	Dynamic	Medium (some market initiatives already on-going)
	Mortgage lenders (D)	+ ↓ funding costs (D) – ↑ reporting costs (D)	Medium to long term	Dynamic	Medium (some market initiatives already on
	Investors (D)	+ ↑ transparency regarding financial instruments and cross-border comparability of information (D)	Medium to long term	Dynamic	Medium (some market initiatives already on
	Member States (D)	≈	n.a.	n.a.	Certain

10.4.5.2.Option 2: Self-regulation

If market participants were willing to engage in such an exercise, such an approach could reduce the different levels of reporting and the differences in definition across Europe, thereby raising transparency for investors, lowering funding costs for mortgage lenders and creating benefits for consumers in terms of lower prices and higher product diversity without lowering data protection. Mortgage lenders would face costs in developing and adopting the new reporting standards, some of which may be in addition to costs arising from national reporting requirements. There would be no additional costs for Member States arising from this option.

One of the advantages of self-regulation would be that since market participants would be responsible for the development of the reporting and definition standards, they could ensure that those standards meet the needs of the investors. In addition, self-regulatory measures would have the benefit of being flexible and easy to modify if product innovation requires a revision of reporting standards.

However, compliance with the reporting standards developed by self-regulation might be below the optimum of 100% if proper enforcement mechanisms are not installed. At the same time however, mortgage lenders would have an incentive to apply the reporting standards as those complying with the standards would benefit from lower funding costs.

Table 62: Impacts of Option 2

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Self-regulation	Consumers (I)	+ ↑ product diversity (I) + ↓ prices (I)	Medium term	Dynamic	Medium to high (depends on willingness of market participants)
	Mortgage lenders (D)	+ ↓ funding costs (D) – ↑ reporting costs (D)	Medium term	Dynamic	Medium to high (depends on willingness of market participants)
	Investors (D)	++ ↑ transparency regarding financial instruments and cross-border comparability of information (D)	Medium term	Dynamic	Medium to high (depends on willingness of market participants)
	Member States (D)	≈	n.a.	n.a.	Certain

10.4.5.3. Option 3: Legislation

A European harmonised framework determining reporting standards and setting out standardised definitions for capital mortgage market funding products would enhance market transparency and the comparability of different mortgage funding instruments.

A legislative framework would oblige Member States to introduce legislation on reporting standards or amend existing legislation. Depending on the level of flexibility in any legislation, a degree of convergence in the reporting of mortgage funding instruments could be ensured. This would raise transparency for investors, lowering funding costs for mortgage lenders and creating benefits for consumers in terms of lower prices and higher product diversity without lowering data protection.

Mortgage lenders would however face costs (one-time and ongoing) for establishing or changing reporting procedures. In addition, Member States, which already have certain legislation on reporting in place, would face administrative costs for changing their legislation according to the suggested reporting standards, depending on the compatibility of the provision of any directive with national law. Other Member States with no legislation would face administrative costs for introducing legislation on reporting.

Table 63: Impacts of Option 3

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Legislation	Consumers (I)	+ ↑ product diversity (I) + ↓ prices (I)	Medium to long term	Dynamic	High
	Mortgage lenders (D)	+ ↓ funding costs (D) – ↑ Reporting costs (D)	Medium to long term	Static (costs) and Dynamic (benefits)	High
	Investors (D)	++ ↑ transparency regarding financial instruments and cross-border comparability of information (D)	Medium to long term	Dynamic	High
	Member States (D)	– ↑ cost for change/adaptation of legislation (D)	Medium to long term	Static	Certain

10.4.6. Comparison of options

Option 1 would only partly fulfil the objective of the Commission to increase transparency for investors because private initiatives with the view to set up reporting standards have already been established for certain mortgage funding instruments such as residential mortgage backed securities. It is however completely uncertain as to whether other market participants will follow this example and establish reporting standards also for other mortgage funding instruments.

Both Options 2 and 3 could in principle ensure that transparency for investors would be increased by the development of reporting and definition standards. The success of Option 2 would be clearly dependent on the efforts undertaken by market participants to develop reporting standards and to comply with them. However, there is a clear incentive for mortgage lenders to comply with the reporting standards set by self-regulation because they would be rewarded with lower funding costs. Under Option 3, mortgage lenders would have no other choice than complying with the reporting standards implemented into national law.

Both options would require some time. For Option 3, an extensive consultation with stakeholders would be required before any setting of reporting standards could be considered in order to make sure that the reporting standards meet the needs of investors. This work has been to a certain extent already undertaken by the ongoing market initiatives in the field of residential mortgage backed securities. In addition, the adoption of a directive would have to pass the legislative process. Any legislation would therefore not enter into effect for several years. Under Option 2, extensive discussions would also have to be undertaken by market participants in order to arrive at reporting standards for mortgage funding products where no private initiatives have been undertaken yet. Such discussions would however also be necessary as part of the better regulation process to develop legislation. Given that such discussions with key stakeholders would be required for both Options 2 and 3, but that further steps would be required to adopt legislation, Option 2 is likely to be able to have a more direct and immediate effect.

Option 2 could ensure that any reporting standards will fully meet the needs of the investors. The eventual extent to which any binding reporting requirements meet the expectations of market participants would be dependent on the outcome of the co-decision process.

In terms of costs, Option 3 could insure that there would be for the purpose of investor information only one set of reporting standards to comply with for each capital market mortgage funding product, therefore imposing only one set of reporting costs on the mortgage lender. Under Option 2 some mortgage lenders might have to comply with more than one set of reporting requirements for investor information for one capital market mortgage funding product, i.e. the national reporting requirements and the reporting standards set by self-regulation. However, the already ongoing initiatives by some market participants to establish reporting requirements might give an indication that the benefits of voluntary pan-European reporting standards, namely lower funding costs, outweigh the costs of complying with those reporting standards in addition to national reporting standards in this respect. No costs for Member States arise from Option 2, while under Option 3 Member States face administrative costs for adapting and introducing legislation.

In conclusion, Options 2 and 3 have both advantages and disadvantages. However, since Option 2 would be a necessary intermediate step for the process in Option 3, at this point in time, Option 2 appears to be preferable compared to Option 3. The Commission could monitor any outcome of self-regulating measures, especially with regard to compliance with other legislation, such as data protection laws. Should the results not be satisfactory, the Commission could consider the introduction of legislation on reporting standards at a later point in time.

Table 64: Overview of effectiveness of different options

Option	Specific		General				Comments
	Promote the development of reporting standards for mortgage funding instruments	Promote the development of standardised definitions for mortgage funding instruments	Cross-border activity	Product diversity	Consumer confidence	Consumer mobility	
Option 1: Do nothing	+	+	≈/+	≈/+	≈	≈	Objectives partly fulfilled; effectiveness uncertain because depending on efforts of market participants
Option 2: Self-regulation	++	++	+	+	≈	≈	
Option 3: Legislation	++	++	+	+	≈	≈	

Assessment: ++ = strongly positive; + = positive; – – = strongly negative; – = negative; ≈ = neutral/marginal; ? = uncertain

10.5. Data protection

10.5.1. Context

Complete and accurate information on the risk connected with a loan is a key factor for both mortgage lenders and investors. The problem of access for mortgage lenders to information on the borrower in order to make the decision whether to grant a credit and at which interest rate is dealt with in Section 4. (Credit registers). It is however equally important for mortgage lenders to be able to disclose the obtained information about a borrower to third parties such as investors, other mortgage lenders or servicers in order to access capital market funding, for instance through the issuance of bonds or the selling of loan portfolios to other mortgage lenders or Special Purpose Vehicles.

For investors who intend to invest in mortgage loan portfolios, for instance through the purchase of residential mortgage backed securities, it is important to receive as much and as accurate information as possible about the loans included in a certain portfolio in order to determine whether to invest and for which premium. Investor's decision will depend on a range of factors including the risk of loan default, the investor's risk appetite and the investor's overall investing strategy. In addition, mortgage lenders who seek to buy mortgage portfolios from other mortgage lenders, for example, to diversify their own portfolios in terms of geographical or risk exposure[325], would need the same information as an investor about the loans included in a given portfolio in order to determine whether to buy and at which price. Information about a loan portfolio might also be required by arrangers[326] that carry out a due diligence to assess the quality of a portfolio, by a rating agency asked to assign a rating to the asset-backed securities collateralised by a portfolio or by third party servicers[327] which are used by mortgage lenders to drive down administrative and processing costs.

The protection of personal data is a fundamental right in the EU set out in Article 8 of the European Convention of Human Rights and Article 8 of the Charter of Fundamental Right of the European Union.[328] The processing of natural person's data in the EU is regulated by the Data Protection Directive[329]. The Directive lays down the conditions for the processing of personal data in the EU as well as for transfers of those personal data to third countries. This legal framework applies to data processing activities performed by mortgage lenders in the framework of their commercial activities as well as to any other commercial activity carried out in the EU. It defines the notion of 'personal data' as any information relating to an identified or identifiable natural person, whereby an identifiable person is one who can be identified, directly or indirectly, in particular by reference to an identification number or one or more factors specific to his physical, physiological, mental, economic, cultural or social identity.[330] 'Processing' of data means the disclosure by transmission, dissemination or

325 See Section 10.3. (Transferability of mortgage loan portfolios to third parties).

326 An arranger is responsible for co-ordinating a transaction, such as a securitisation transaction, with respect to the originator/client, the law firms, the rating agencies and other third parties. See *A Framework for European Securitisation*, European Securitisation Forum, May 2002, p. 12.

327 Mortgage servicing comprises the 'day-to-day' administration and management of mortgage loans from their inception to final payment. Administration includes calculation and collection of monthly principal and interest payments, maintaining bank accounts in securitisation transactions, paying taxes and insurance premiums and taking steps to collect overdue payments including foreclosure. See footnote 171, p. 62.

328 Charter of Fundamental Rights of the European Union (2000/C 364/01), 18.12.2000.

329 Directive 95/46/EC, 24.10.1995.

330 Article 2(a) of Directive 95/46/EC, 24.10.1995.

otherwise making available.[331] As a general rule, the processing of personal data needs to be legally grounded on one of the appropriate legal basis' set out in Article 7 of the Directive[332], such as, for instance, the unambiguous consent of the data subject.

In addition, the Data Protection Directive sets out that personal data must only be collected for a specified, explicit and legitimate purpose, it must also be adequate, relevant and not excessive in relation to the purposes for which it is collected and must be not further processed in a way incompatible with those purposes. It cannot be processed for a period longer than is necessary for the purposes for which the data was collected (purpose limitation and proportionality principles, Article 6 of the Data Protection Directive). The Directive also provides for the right of the data subject to information, access, rectification and deletion or blocking of personal data (Articles 10–12).

10.5.2. Problem

As said before, the framework set out by the Data Protection Directive provides the legal framework for the processing of personal data in the EU. The Directive lays down the conditions that national data protection laws need to apply to data processing activities carried out in their territory.[333].

According to industry stakeholders[334], this legal framework raises several issues with regard to the transfer of a borrower's data between different mortgage lenders, mortgage lenders and investors, or a mortgage lender and other third parties for the purposes described above. Without detailed information on the loans included in the portfolio and on the borrower such as the mortgage product selected, payment terms, property location, debt to income ratios or loan-to-value ratios, an investor may either decide against investing in a mortgage loan portfolio or at least demand a risk premium for the lack of information, resulting in higher refinancing costs for the mortgage lender.[335] The higher refinancing costs for mortgage lenders will in turn translate into higher borrowing costs for consumer or potentially to the exclusion of certain borrowers. The latter could happen if the risk premium demanded by an investor for the lack of information would be so high that the borrower could no longer afford the resulting interest rate.[336]

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331 Article 2(b) of Directive 95/46/EC, 24.10.1995.

332 Member States shall provide that personal data may be processed only if: (a) the data subject has unambiguously given his consent; or (b) processing is necessary for the performance of a contract to which the data subject is party or in order to take steps at the request of the data subject prior to entering into a contract; or (c) processing is necessary for compliance with a legal obligation to which the controller is subject; or (d) processing is necessary in order to protect the vital interests of the data subject; or (e) processing is necessary for the performance of a task carried out in the public interest or in the exercise of official authority vested in the controller or in a third party to whom the data are disclosed; or (f) processing is necessary for the purposes of the legitimate interests pursued by the controller or by the third party or parties to whom the data are disclosed, except where such interests are overridden by the interests for fundamental rights and freedoms of the data subject which require protection under Article 1(1) of Directive 95/46/EC, 24.10.1995.

333 For an overview of national laws applying to data protection, see footnote 14, p. 40.

334 Cf. footnote 171, p. 23.

335 Cf. footnote 171, p. 23.

336 Although the requirement of detailed investor information is important for the funding of mortgage credit, it goes far beyond the scope of mortgage credit, applying to all types of credit which can be securitised for investment purposes.

10.5.2.1.Definition of 'personal data'

The definition of 'personal data' is perceived by industry stakeholders as abstract and being a source of legal uncertainty.[337] It is seen as making it difficult for mortgage lenders who want to use capital market funding to provide detailed information on a loan-by-loan basis to third parties, because of uncertainty as to whether any information they could disclose could be considered to be 'personal data' and therefore subject to data protection law. Some information about the borrower and the collateral, such as the property location, debt to income ratio, the mortgage product selected, payment terms, loan-to-value ratios etc., is sufficient on its own, or could be sufficient together with other information, to identify the borrower and would therefore qualify as 'personal data', therefore subjecting the processing of this information to the rules of the Data Protection Directive. Industry stakeholders believe that this could result in restricted data processing possibilities, since the disclosure of this information to third parties is subjected to the principles of the Directive and has to comply with it. For instance, information on the postcode in the UK, which is useful for an investor in order to determine the location of the property and therefore to assess the geographical diversification of a loan portfolio, could be already sufficient to identify – together with other information given – a single borrower since the number of represented houses in the specific postcode area might be low enough. The disclosure of the postcode to a potential investor could therefore require in some Member States, in the absence of one of the legal bases listed in Article 7 of the Directive for processing personal data, the consent of the borrower which the borrower might not have been given. As a consequence and to avoid any unclear situation, according to the information provided to the Commission[338], mortgage lenders securitising their loan portfolios report currently aggregate pool data rather than on a loan-by-loan basis, for instance on a residential mortgage backed securities portfolio. This lack of detail, however, may deter some investors from purchasing residential mortgage backed securities, which in turn raises borrowing costs for mortgage lenders, or may increase the funding costs directly as investors charge a premium for the lack of information to cover for potential hidden risks. As mentioned before, this may have a negative impact on prices for consumer or might even exclude some potential mortgage borrowers because mortgage lenders might not be able to offer certain mortgage products if they cannot get appropriate funding for them.

In a recent opinion[339], the Article 29 Data Protection Working Party[340] published a detailed interpretation on the concept of 'personal data'. The document aims to introduce a uniform interpretation and application of the Data Protection Directive in order to enhance legal certainty. This opinion could contribute to enhancing legal certainty and the clarification of doubts amongst industry stakeholders about what information is to be considered as 'personal data' and put the described problem into perspective. Although the opinion does not focus on the disclosure of information required in the process of refinancing of mortgage credit, it provides a general analysis of whether a piece of information should be considered as 'personal data' the processing of which will be subject to data protection law. The analysis is

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337 Cf. footnote 171, p. 24.

338 Cf. footnote 171, p. 24.

339 *Opinion 4/2007 on the concept of personal data*, Article 29 Data Protection Working Party, 20.6.2007, http://ec.europa.eu/justice_home/fsj/privacy/docs/wpdocs/2007/wp136_en.pdf.

340 The Working Party on the Protection of Individuals with regard to the processing of Personal Data was set up by Article 29 of Directive 95/46/EC, 24.10.1995. It is an independent European advisory body on data protection and privacy. Its tasks are described in Article 30 of Directive 95/46/EC, 24.10.1995. The secretariat is provided by the European Commission.

supported by examples from national practices of European Data Protection Authorities.[341] The enhanced legal certainty which this option should bring to the concept of 'personal data' should also benefit investors who should receive clearer information. Since this opinion is not changing the scope of the notion of 'personal data' as such, but will only clarify it, borrowers will not be affected by the opinion of the Working Party.

The opinion of the Article 29 Working Party is not legally binding. However, there would be a certain expectation and peer pressure among Member States data protection authorities that this opinion which they have contributed to develop would be taken into account. However, if Member States do not follow the interpretation given in the opinion of the Data Protection Working Party, the Commission would not have the opportunity to interfere or to enforce the rules.

Although the opinion of the Data Protection Working Party undertakes an extensive analysis of the concept of 'personal data', it leaves still some discretion to Member States. This is due to the intended broad notion of 'personal data' because the objective of the Data Protection Directive is to cover all situations where the fundamental rights and freedoms of individuals, in particular their right to privacy, could be at risk and hence need to be protected. Even with the application of these guidelines through Member States, it is not excluded that there might still be some uncertainty in the future as regards the notion of 'personal data'.

10.5.2.2. Requirement of borrower's consent as the legal basis for the processing of personal data

'Personal data' can be processed under certain conditions, provided that they are justified in accordance with one of the legal bases set out by Article 7 of the Data Protection Directive. Article 7 provides for six legal bases that make the processing of personal data a legitimate activity[342]. According to Article 7, one of the legal bases is the unambiguous consent of the borrower, however it is not the only legal basis for the processing of data to third parties. Member States can, according to Article 7 of the Data Protection Directive, provide for the processing of 'personal data' without the unambiguous consent of the borrower if the processing is necessary for one of the other reasons listed in Article 7(b)–(f) of the Data Protection Directive.[343] Based on the information provided to the Commission, some Member States have introduced national provisions which allow in specific cases the processing of 'personal data' without the consent of the borrower. For instance, in Greece, for securitisation purposes, a mortgage lender is allowed to furnish a special purpose vehicle with any information and data related to the securitised assets and the debtors and, similarly, a special purpose vehicle might provide such information and data to note holders.[344]

[341] One example refers to the value of a house and whether this could be considered as personal data. See footnote 339, p. 9.

[342] See footnote 332.

[343] For instance, Member States shall provide, that personal data may be processed if processing is necessary for the purposes of the legitimate interests pursued by the controller or by the third parties to whom the data are disclosed, except where such interests are overridden by the interests for fundamental rights and freedoms of the data subject which require protection under Article 1(1) of Directive 95/46/EC, 24.10.1995.

[344] Information provided by stakeholders to the Commission.

If, however, consent is the only legal basis for the processing of data to third parties then, pursuant to the Directive, for consent to be a valid legal ground for the processing of a data subject's personal data, it has to be a freely given, specific, and informed indication of the borrower's wishes, in which the data subject signifies his agreement to personal data relating to him being processed.[345] In such a case, the borrower has to be clearly informed about the purposes of the processing for which the data is intended. For example, specific borrower consent would be required in the event that the mortgage lender would disclose the personal data collected to potential investors in securities issued by the mortgage lender for a specific purpose, if this purpose is different from the initial interest of the mortgage lender to collect data in order to enable him to make his lending decision.

The requirement for the consent of the data subject is intended to protect individuals against the unlawful processing of his personal data. However, mortgage lenders claim that where 'consent' is the legal basis used for the processing of personal data that they carry out, it could impose difficulties in practice. For instance, if a mortgage lender wishes to sell or securitise a mortgage loan portfolio, the mortgage lender would need to obtain consent from all borrowers whose loans are included in the loan portfolio in order to be able to disclose the personal data of all borrowers included in the portfolio to potential investors. However, by transferring personal data in the context of assignments for securitisation purposes, without the consent from the borrower to do so, to investors, the mortgage lender could be in conflict with the Data Protection principles because he might be in breach of the purpose limitation principle.[346]

Where the consent of the borrower is required in order to disclose information to third parties, mortgage lenders consider that they may face certain administrative costs in order to comply with the Directive. The level of costs depends on how the need for the data subject's consent has been implemented by Member States and at which point in time the mortgage lender is asking for the consent of the borrower. With regard to the implementation of the data subject's consent, some Member States require the explicit consent of the data subject,[347] whereas in others,[348] a tacit consent following the receipt of a notification of the data transfer suffices.[349] The administrative cost for obtaining the consent of the borrower could therefore vary across the different Member States and might be higher in those Member States where an explicit authorisation of the data subject is required. In this case, a mortgage lender would have to write to all borrowers concerned and needs to file all receipts to prove authorisation.

The unambiguous consent of the borrower for the different purposes for which the data is collected and can be further disclosed, can however, be obtained at the moment that the mortgage lender collects the 'personal data' for the first time e.g. at the conclusion of the contract. This would lower the costs of obtaining consent substantially, especially when compared to seeking consent at a later stage. While this would solve the problem for newly originated mortgage loans, it cannot solve the problem for existing mortgage loans.

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345 Article 2(h) of Directive 95/46/EC, 24.10.1995.

346 Cf. footnote 256, p. 53.

347 For instance, in Austria, France, Germany, Italy, Luxembourg and the Netherlands. However, exceptions apply in some jurisdictions that no prior approval from the debtor is required. This is the case for instance in Austria, if data is transferred from a credit institution to a Special Purpose Vehicle, or in Germany, if it is necessary to provide rating agencies with required information.

348 According to information provided to the Commission, this is the case for instance in Portugal.

349 Cf. footnote 171, p. 23.

While acknowledging the existence of some costs for the mortgage lender in the event that the borrower's consent for processing personal data can only be obtained at a later stage, the importance of requirement of consent for consumers has to be taken into account. The Data Protection Directive intends to ensure the respect of the autonomous right to the protection of personal data, which is recognised in Article 8 of the European Charter of Fundamental Right[350]. In the light of this right, the Data Protection Directive requires Member States to allow the processing of 'personal data' when the processing is covered by any one of the legal bases laid down in Article 7 of the Data Protection Directive.

In conclusion, based on the information that has currently been provided to the Commission, the actual cost of the need for borrower's consent and the divergent implementation of Member States with regard to the requirement of explicit and tacit consent is currently unclear. No precise figures have been presented in this respect. However, based on the information currently available, even if the existence of some costs connected with the need for borrower's consent has to be acknowledged, it appears to be doubtful that those costs are so material that they are unjustifiable high for mortgage lenders. In addition, at this stage, no barriers to the mortgage lender asking at the moment when the data is collected for the first time for the borrower's unambiguous consent for the different purposes for which the data is collected and can be further disclosed have clearly been identified. The Commission considers therefore at this stage that any action with regard to the requirement of borrower's consent as the legal basis for the processing of personal data would be premature.

Table 65: Problems and consequences

Problem	Consequences
Data protection: ▪ Uncertainty regarding the definition of personal data	For mortgage lenders: – Higher refinancing costs => reduced scope for economies of scale – Inability to access refinancing for certain products => reduced product diversity For investors: – Lack of transparency – Inability to accurately identify appropriate products => Reduced demand For consumers: – Higher prices – Reduced product diversity

350 Charter of Fundamental Rights of the European Union (2000/C 364/01), 18.12.2000.

10.5.3. Objectives

The specific objectives here are threefold:

- Reduce uncertainty with regard to the notion of 'personal data' in order to enable mortgage lenders to have a clear understanding of the EU legal framework applicable to the processing of personal data and a clear understanding under which conditions mortgage lenders may provide third parties (e.g. investors, other mortgage lenders and servicers) when necessary with certain data on a loan-by-loan basis in order to enable them to make an informed decision;

- Ensure that mortgage lenders comply with data protection laws while performing their activities and that they do not face unnecessary costs, in particular while they lawfully provide data to investors;

- Ensure that borrowers' fundamental right to privacy is protected when mortgage lenders process personal data in the pursuit of their activities.

10.5.4. Description of options

10.5.4.1. Option 1: Article 29 Data Protection Working Party

The recent opinion published by the Article 29 Data Protection Working Party should contribute to a uniform interpretation and application of the Data Protection Directive and thus enhance legal certainty. However, since the opinion of the Article 29 Data Protection Working Party is not legally binding, Member States might not be following the interpretation given in that opinion. In addition, even with the application of the guidelines through Member States, there might still be some uncertainty in the future as regards the notion of 'personal data'. In order to address those issues, the Article 29 Data Protection Working Party declares in its opinion that it intends to revisit the subject in due course, with view to further enhancing the common understanding of the key concept of 'personal data', and ensuring a harmonised application and a better implementation of the Data Protection Directive.

10.5.4.2. Option 2: Amendment of the Data Protection Directive

The Data Protection Directive could potentially be amended to clarify the notion of 'personal data'. However, after a close monitoring of the implementation of the Directive, the Commission has recently stated in its Communication on the follow-up of the Work Programme for better implementation of the Data Protection Directive[351], that the Directive constitutes a general legal framework which fulfils its original objectives by constituting a sufficient guarantee for the functioning of the Internal Market while ensuring a high level of protection. Accordingly, the Commission does not envisage submitting any legislative proposal to amend the Directive in the near future. Instead, the Commission has announced its intention to issue interpretative guidelines or communications and increase its work aimed at ensuring proper implementation and reducing divergences between national laws. An amendment of the Data Protection Directive in the near future is therefore not a realistic option.

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[351] COM(2007) 87 final, 7.3.2007.

10.5.5. Impact assessment

10.5.5.1.Option 1: Article 29 Data Protection Working Party

It cannot be assessed at this stage whether the opinion published by the Article 29 Data Protection Working Party will indeed fulfil its objective to contribute to a uniform interpretation and application of the Data Protection Directive and thus to enhance legal certainty in terms of the definition of 'personal data'. However, it is expected that this opinion will indeed do so, thus improving the understanding of the EU data protection legal framework and therefore reducing the legal uncertainty which is perceived by industry stakeholders.

The implementation of the opinion of the Article 29 Data Protection Working Party will be revisited in due course, with view to further enhancing the common understanding of the key concept of 'personal data', and ensuring a harmonised application and a better implementation of the Data Protection Directive. This option should therefore ensure in the long run that mortgage lenders face less uncertainty with regard to the notion of 'personal data' and that they are therefore able to provide third parties with certain data on a loan-by-loan basis.

Table 66: Impacts of Option 1

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Article 29 Data Protection Working Party	Consumers (D + I)	≈/+ ↑ product diversity (I) ≈/+ ↓ prices (I) ≈ on the level of data protection (D)	Medium to long term.	Dynamic	Medium
	Mortgage lenders (D + I)	+ ↑ certainty with regard to the definition of 'personal data' (D) + ↓ refinancing costs (I)	Short to medium term	Dynamic	Medium
	Investors (I)	+ ↑ access to data (I)	Short to medium term	Dynamic	Medium
	Member States (D)	– ↑ costs due to implementation of the opinion of the Data Protection Working Party (D)	Short to medium term	Static	Medium

Table 67: Overview of policy option effectiveness

Option	Specific			General				Comments
	Reduce uncertainty of notion of 'personal data'	No unnecessary costs when providing data	Borrower's right to privacy	Cross-border activity	Product diversity	Consumer confidence	Consumer mobility	
Article 29 Data Protection Working Party	+	≈	≈	≈/+	≈/+	≈	≈	Final impact would depend on willingness of Member States to take opinion of Article 29 Data Protection Working Party into account. Still some discretion for Member States.

Assessment: ++ = strongly positive; + = positive; – – = strongly negative; – = negative; ≈ = neutral/marginal; ? = uncertain

10.6. Basel II

10.6.1. Context

The purpose of Basel II is to make regulatory capital requirements for banks more risk-sensitive, to encourage banks to improve their risk management processes and to facilitate market discipline on banks. The Capital Requirements Directive implements Basel II in Europe. The Directive had to be transposed into Member States' national legislation by 31 December 2006.

Although directly affecting only banks and, in Europe, investment firms, issuers and investors will be indirectly affected by potentially resulting changes in the funding and investment patterns of banks.[352]

10.6.2. Problem description

10.6.2.1. Possibility of differences in interpretation and application of the Capital Requirements Directive across jurisdictions

The Capital Requirements Directive leaves discretion to national regulators on how to interpret and apply some of its provisions. For instance, the Capital Requirements Directive sets out minimum requirements for the recognition of 'significant risk transfer'[353], leaving however certain discretion for supervisors to decide if a 'significant risk transfer' has taken place or not. As a consequence, the same transaction aimed at achieving regulatory capital relief for the assets that have been securitised might be treated differently in different jurisdictions. Certain types of transaction might therefore not be used in some jurisdictions.

352 Cf. footnote 171, p. 37.

353 Where a securitisation transaction achieves 'significant risk transfer' in accordance with Article 95(1) of Directive 2006/48/EC, 14.6.2006, the originator credit institution may in the case of a traditional securitisation, exclude the securitised exposures from the calculation of its capital requirements; instead, it has to calculate capital requirements for positions in the securitisation that it retains. An analogous treatment is provided for in the case of synthetic securitisations.

Other examples concern the notion of 'implicit support'[354] and the treatment of the counterparty risk of swaps with Special Purpose Vehicles.

The different interpretation and implementation possibilities for Member States could therefore lead to varying degrees of regulatory capital relief for identical structures or credit risk mitigation tools used in different Member States, thereby discriminating against certain structures or tools, or imposing higher refinancing costs for certain mortgage originators in some jurisdictions. As such, the higher costs for refinancing could be transferred to consumers who would consequently face higher interest rates for their mortgages.

The Commission is already taking concrete measures to address the risk of diverging national approaches by issuing transposition guidance to secure the consistent interpretation and application of the Capital Requirements Directive across Member States. To this end, a Capital Requirements Directive Transposition Group was set up together with Member States that provides, in collaboration with the Committee of European Banking Supervisors (CEBS), answers to queries that all interested parties can post on the web site of the Commission. In addition, the Commission has called for technical advice[355] from the Committee of European Banking Supervisors as to how the number of options and discretions can be reduced by way of amendments to the directive text. The Committee of European Banking Supervisors is expected to respond, after due consultation with the industry, by May 2008.

10.6.2.2. Sunset clause for eligibility of residential mortgage backed security tranches as cover assets for covered bonds

The Capital Requirements Directive provides for a preferential treatment for covered bonds so that banks generally need to hold less capital for these collateralised bonds compared to normal bank bonds. To qualify for this treatment, covered bonds need to be backed by eligible collateral assets as listed in this Directive. Subject to prudent loan-to-value limits, mortgage loans feature on this list. In addition, the collateral requirement for covered bonds can be met up to 20% by senior tranches of certain securitisation entities that securitise qualifying mortgage loans. Until 31 December 2010 however, the 20% limit does not apply under certain conditions[356] thereby allowing those senior units to constitute 100% of cover assets for covered bonds. Consequently, as long as this derogation is available and subject to certain requirements, mortgage lenders have in principle the choice of either backing a covered bond with eligible mortgage loans or securitising the eligible mortgage loans first and then using the senior tranches of the securitisation as collateral for the covered bond. The derogation was made subject to a sunset clause because time did not allow for a thorough assessment of the suitability of residential mortgage backed securities as 100% of cover assets. According to the Mortgage Funding Expert Group,[357] those mortgage lenders that make use of more than 20% of senior tranches of securitised mortgage loans in their cover pools therefore face uncertainty as to whether these securitisation tranches will qualify beyond 2010 as up to 100% of the eligible assets in a cover pool. The group therefore asks for the sunset clause and consequently the 20% limit to be abolished immediately.

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[354] Cf. footnote 171, p. 38.

[355] See for further information on the Call for Technical Advice http://www.c-ebs.org/Advice/documents/CFA10onnationaldiscretions16052007.pdf.

[356] See the conditions set out in Annex VI, Part 1, point 68 of Directive 2006/48/EC, 14.6.2006.

[357] Cf. footnote 171, p. 39.

However, the sunset clause should have no significant effect on the mortgage funding chain. The Capital Requirements Directive imposes the same requirements on loans that are securitised and then used as collateral for a covered bond as it imposes on loans that are directly used as collateral for a covered bond. Consequently, if a mortgage lender or a group of mortgage lenders wanted to refinance a given pool of mortgage loans that met covered bond eligibility standards of the Capital Requirements Directive, they could, rather than selling them to a securitisation entity as an intermediate step, sell them directly to a covered bond issuer. Mortgage lenders currently taking this intermediate step via a securitisation entity may use the timeframe provided by the sunset clause to adjust their refinancing strategies to the new eligibility standards for covered bonds in the Capital Requirements Directive and save the cost of the intermediate securitisation entity structure. To the limited extent that covered bond issuers wish to use securitisation tranches as an addition[358] to their cover pools, the permanent 20% limit would provide the necessary flexibility. So far the Commission is not aware of evidence that a 20% limit would not provide the necessary flexibility. The Commission considers at this stage that reviewing the sunset clause for the eligibility of residential mortgage backed security tranches as cover assets for covered bonds in good time before its expiry rather than immediately abolishing it should not impose a problem for mortgage lenders issuing covered bonds.

Table 68: Problems and consequences

Problem	Consequences
▪ Possibility of differences in interpretation and application of the Capital Requirements Directive across jurisdictions	For mortgage lenders: – Distorted playing field => different refinancing costs among mortgage lenders – increased compliance cost for cross-border groups => Mortgage lenders may be deterred from cross-border activity => Reduced competition For consumers: – less competition => potentially higher prices

10.6.3. Objectives

Specifically, with regard to Basel II, the Commission aims to promote a consistent interpretation and application of the Capital Requirements Directive across Member States which would also facilitate a level playing field in the area of mortgage funding instruments.

358 In general, issuers of mortgage bonds use replacement cover of a high quality to bridge temporary shortages of eligible mortgage loans and to manage the term structure of the cover pool. In addition to public debt and the limited use (15% of the cover pool) of bank deposits, eligible tranches of mortgage back securities may be considered an additional means of replacement cover.

10.6.4. Description of options

10.6.4.1. Option 1: Continuation of processes initiated by the Commission to promote further convergence of interpretation and application of the Capital Requirements Directive

The Commission has already initiated processes to address the risk of diverging national approaches with the issuance of transposition guidance by the Capital Requirements Directive Transposition Group and the call for technical advice from the Committee of European Banking Supervisors as to how the number of options and discretions in the Capital Requirements Directive can be reduced.

10.6.5. Impact assessment

10.6.5.1. Option 1: Continuation of process initiated by the Commission to promote further convergence of interpretation and application of the Capital Requirements Directive

The work currently undertaken by the Commission could meet the objective of the Commission to promote a consistent interpretation and application of the Capital Requirements Directive across Member States which would also facilitate a level playing field in the area of mortgage funding instruments.

The transposition guidance issued by the Capital Requirements Directive Transposition Group contributes already to a more uniform interpretation and application of the Capital Requirements Directive across Member States. This approach has already helped sort out over 260[359] difficult issues that also cover a number of specific securitisation topics such as 'implicit support' in specific structures and the treatment of exposures to the Special Purpose Vehicle. As a consequence, this approach contributes to the achievement of a level playing field between mortgage lenders in terms of capital relief for certain refinancing structures. This has a positive impact on consumers which benefit from higher competition and, potentially, lower prices.

While the views of the Capital Requirements Directive Transposition Group cannot be legally binding, there is commitment by Member States that the views of the Transposition Group will be implemented when transposing and interpreting the provisions of the Capital Requirements Directive. Should there be infringement procedures against a Member State, the Commission itself is committed to defend the guidance of the Requirements Directive Transposition Group as its own interpretation of the Directive where applicable.

The call for technical advice from the Committee of European Banking Supervisors about further harmonisation by reducing the number of discretions and options in the Capital Requirement Directive will also contribute to further convergence. Based on the outcome of the technical analysis and stakeholder consultation undertaken by the Committee of European Banking Supervisors, the Commission intends to make, where appropriate, targeted legislative proposals and/or use its powers of execution in order to ensure the effectiveness of this convergence effort.

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[359] As of 24.10.2007.

This process initiated will lead over time to the same capital relief for identical structures or credit risk mitigation tools used in different Member States, therefore ensuring a level playing field for mortgage lenders. Consumers consequently have the potential of benefiting from lower prices due to higher competition between mortgage lenders.

Table 69: Impacts of Option 1

Option	**Affected parties** Direct impact (D) Indirect impact (I)	**Impacts** ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	**Timing** One-off Short-term Medium-term Long-term	**Nature** Dynamic Static	**Likelihood** Certain High Medium Low
Continue Commission process for further convergence of the Capital Requirements Directive	Consumers (I)	+ ↓ prices (I)	Medium to long term	Dynamic.	Medium
	Mortgage lenders (D)	+ ↑ level playing field in terms of regulatory capital relief for funding instruments (D)	Medium to long term	Dynamic.	High
	Member States (D)	– ↑ costs for amendment of national legislation (D)	Medium term	Static	Uncertain (depending on outcome of consultation process)

Table 70: Overview of policy option effectiveness

Option	**Specific**	**General**				**Comments**
	Consistent interpretation and application of the Capital Requirements Directives	**Cross-border activity**	**Product Diversity**	**Consumer confidence**	**Consumer mobility**	
Continue Commission process for further convergence of the Capital Requirements Directive	+/++	+	≈	≈	≈	Issuance of transposition guidance by the Capital Requirements Directive Transposition Group and call for technical advice from the Committee of European Banking Supervisors as to how the number of options and discretions in the Capital Requirements Directive can be reduced.

Assessment: ++ = strongly positive; + = positive; – – = strongly negative; – = negative; ≈ = neutral/marginal; ? = uncertain; N.A. = not applicable

10.7. House price indices

10.7.1. Context

In most EU countries there exist some kind of residential property price indicators produced by government bodies, such as statistical institutes, other government bodies, central banks and central banks collaborating with bodies outside government, which, however, are of varying quality and do not necessarily fulfil the conditions of a proper price index.[360]

The ECB currently compiles and publishes a semi-annual indicator of euro area residential property prices based on non-harmonised data, weighted using national GDP shares (instead of transaction or housing stock-based weights which are not available for all countries).

As far as housing costs are concerned, the EU Harmonised Indices of Consumer Prices (HICP) measures price changes for rented housing and for minor repairs and maintenance, while the most part of the expenditures on owner-occupied housing – be it dwelling prices or the costs of the service rendered to owner occupiers – are currently excluded. With a view to potentially including owner-occupied housing in the Harmonised Indices of Consumer Prices, Eurostat, the statistical office of the European Commission, launched a pilot study in 2001. The intention is to produce a house price index, which will serve the needs of the Harmonised Indices of Consumer Prices and, as a self-standing index in its own interest, the needs of those users whose main interest is in the house price indices per se. Eleven countries[361] are participating in the current pilot work with financial support from Eurostat. In addition to those eleven countries, France is working in co-operation with the project. The remaining Member States are expected to join the project in the near future.[362] Although a final decision is expected to be made in 2009 as to whether the house price index developed on a pilot basis should be included in the Harmonised Indices of Consumer Prices, the Commission is aware of an established user need for house prices indices. Against this background, the Commission is considering giving a legal basis for a self-standing index of house prices to be produced and published regularly regardless of the final decision on the treatment of housing in the HICP.

Alternative data sources with respect to house prices are provided by real estate agencies, mortgage banks and notary organisations.

10.7.2. Problem description

Euro area residential property prices have been relatively dynamic on average over the last five years. For mortgage lenders and investors in mortgage backed securities alike it is however important to closely monitor house price developments because the property forms the underlying security of the mortgage loan. This touches on several issues.

First, in the event that the mortgage borrower fails to meet the conditions set out in the mortgage loan contract, mortgage lenders and investors must be sure that the value of the mortgaged property is high enough to cover the claim. Since a mortgage loan is usually

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360 Information provided by Eurostat.

361 Cyprus, Finland, Germany, Greece, Italy, Poland, Slovakia, Slovenia, Spain, Netherlands and United Kingdom.

362 More information, for instance on the approach taken by Eurostat, can be obtained http://epp.eurostat.ec.europa.eu/pls/portal/docs/PAGE/PGP_DS_HICP/TAB61582098/CPS%202007-61-11-EN%20-%20OOH%20PROGRESS%20REPORT-REVTABLE.PDF.

provided over a long period, fluctuations in the value of the property are likely. A mortgage lender is therefore interested in protecting himself against the risk of falling property prices to avoid the situation that the value of the property is lower than the outstanding amount of the loan. This can be done in general in two ways. A mortgage lender could grant loans to borrowers with a lower loan-to-value ratio.[363] While this solution would be suitable for protecting to some extent the mortgage lender – and consequently investors – against falling property prices, this solution lead to the exclusion of some borrowers, such as borrowers with lower income and low savings. Another possibility for the mortgage lender would be to hedge the mortgage portfolio against falling property prices. A mortgage lender could do that by charging the borrower a risk premium or by buying protection in the market. However, for the latter, a standardised, comparable house price index is needed that is sufficiently disaggregated by type of dwelling and location.[364] This solution would allow relatively high loan-to-value ratios, thus potentially enabling consumers with a lower capital base to enter the housing market.

Second, the monitoring of house prices is indispensable for the provision of certain products in order to monitor the development of house prices and calculate a number of assumptions for house price inflation. For instance, to offer a 'lifetime mortgage', which is one main type of equity release schemes, the homeowner takes out a mortgage loan secured on their property, which is repaid when the property is sold. Since the repayment of capital and payment of interest is deferred until the property is sold, the mortgage lender has to make a reliable judgement about the future development of property prices in order to ensure that he is able to recover the granted money. A house price index, which gives reliable information on the change of house prices over time, would therefore be extremely useful and could contribute to the range of mortgage products being offered in a market.

Third, it is also useful investors entering foreign markets to be able to draw on a house price index for information on changes of house prices. Taking this information into account, investors will make their decisions whether to invest in a given market or not. In markets where reliable information on changes of house prices is not available, investors might decide against investing due to the lack of transparency. A lower investor base however makes it more difficult for mortgage lenders to obtain funding for their mortgage loans, therefore possibly increasing the cost for funding and lowering the range of products that can be offered to borrowers.

Standardised, comparable data on changes of house prices is not currently available across Europe. The existing different national house price indices are not standardised in terms of the used methods to compile the data and therefore not comparable. Data on house price development provided by real estate agencies, mortgage banks and notary organisations vary not only in frequency and timeliness, but also have several shortcomings such as an incomplete coverage in terms of region and dwelling type, different price recording practices (e.g. offer prices versus purchaser prices) and different methods for adjusting price data for varying dwelling characteristics.[365]

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363 The loan-to-value ratio is the mortgage loan balance divided by the value of the property. See footnote 171, p. 71.

364 Cf. footnote 171, p. 40.

365 See 'Assessing the house price developments in the euro area', *ECB Monthly Bulletin*, February 2006, p. 57.

As a result, mortgage lenders might face higher funding costs due to lack of investor interest or might not even get funding for certain products, which in turn will impact on borrowers in higher prices or a lower range of available products.

Table 71: Problems and consequences

Problem	Consequences
Lack of standardised, comparable House Price Indices across the EU.	For mortgage lenders: – Lack of transparency – Higher refinancing costs => reduced scope for economies of scale – Inability to access refinancing for certain products => Mortgage lenders may be deterred from cross-border activity => Reduced competition For consumers: – Limited consumer choice – Restricted access to mortgage products for certain borrowers such as lower income borrowers or older consumers – Higher prices For investors: – Lack of transparency – Inability to accurately identify appropriate products – => Reduced demand

10.7.3. Objectives

The Commission aims to ensure the availability of standardised, comparable data on changes of house prices across Europe.

10.7.4. Description of options

10.7.4.1.Option 1: Continuation of pilot work undertaken by Eurostat

The Commission (Eurostat) is already carrying out a study with the view to potentially including owner-occupied housing in the Harmonised Indices of Consumer Prices. The outcome will be a house price index, which – in addition to serving the needs of the Harmonised Indices of Consumer Prices – can serve the described needs of mortgage lenders and investors. It is likely that Eurostat will propose soon a specific legal basis within the HICP legal framework.

10.7.4.2.Option 2: Commission recommendation

The Commission could in parallel issue a recommendation to encourage Member States to develop national house price indices. This recommendation could set out certain standards and methods for setting up a house price index, such as the price recording practices (e.g. offer or purchaser prices). However, this option does not seem appropriate for several reasons. First, in most Member States there is already some sort of house price indicator. A new house price index would mean additional costs for Member States to compile the data in a specific way. Member States might therefore choose not to follow the recommendation of the Commission. Second, considerable groundwork has been undertaken already with Option 1, providing already the first results in terms of the delivery of comparable data for changes in housing prices in some of the pilot Member States. Option 2 would therefore duplicate the efforts and costs already undertaken in the 12 Member States participating in the pilot study of Eurostat. Even for the Member States currently not yet participating in the pilot phase of the Eurostat project, it is unlikely that a recommendation to Member States delivers faster results than Option 1 because under the Eurostat project it is foreseen that all Member States join the project until 2009. Option 2 can therefore be discarded already at this stage.

10.7.5. Impact assessment

10.7.5.1.Option 1: Continuation of pilot work undertaken by Eurostat

The study currently undertaken by Eurostat with the view to develop a house price index could potentially meet the objective of the Commission to ensure the availability of more standardised, comparable data on changes of house prices with European-wide country coverage for mortgage lenders. Although the main purpose of this study is to develop a house price index that serves the needs of the Harmonised Indices of Consumer Prices in the first place, this index will also be made available to other parties whose main interest is in house price indices per se, such as mortgage lenders and investors in mortgage backed investment products.

Mortgage lenders could benefit from lower funding costs due to higher transparency for investors on the risks of a change in housing prices. The lower funding costs could potentially translate into lower product prices for consumers. Certain consumers such as lower income consumers in need for mortgage loans with a high loan-to-value ratio or older people wishing to release some of the capital accumulated in their homes could further benefit from a broader range of mortgage products as described above. Member States would face administrative costs for compiling the necessary data, which could duplicate costs in certain Member States which already have established national house price indices. The administrative burden for Member States has been recognised by the Commission when Eurostat started the study on property price indices. The Commission provides financial support for the initial pilot work to be undertaken in Member States and for implementing new statistical requirements, thereby lowering to some extent the financial burden for Member States.

Eurostat is currently reviewing and assessing the quality of the data provided by the pilot Member States so far. Since a final decision as to whether the house price indices developed on a pilot basis are actually achieving the objective of the provision of standardised, comparable data on changes of house prices on EU-wide coverage will be made in 2007, it can then be evaluated whether these indices may fully serve the needs of mortgage lenders.

Table 72: Impacts of Option 1

Option	Affected parties Direct impact (D) Indirect impact (I)	Impacts ++ = strongly positive + = positive – – = strongly negative – = negative ≈ = neutral/marginal ? = uncertain	Timing One-off Short-term Medium-term Long-term	Nature Dynamic Static	Likelihood Certain High Medium Low
Continue Eurostat project	Consumers (I)	+ ↑ product diversity (I) + ↓ prices (I)	Medium to long term	Dynamic	Medium (depending on outcome of the Eurostat study)
	Mortgage lenders (D)	+ ↓ refinancing costs through more transparency because of more standardised, reliable data on house price changes (D)	Medium to long term	Dynamic	Medium (depending on outcome of the Eurostat study)
	Investors (I)	+ ↑ level of transparency for investor products secured by mortgaged property (I)	Medium to long term	Dynamic	Medium (depending on outcome of the Eurostat study)
	Member States (D)	+ ↑ costs for compiling data (D)	Medium to long term	Dynamic	Medium (depending on outcome of the Eurostat study)

Table 73: Overview of policy option effectiveness

Option	Specific objectives	General objectives				Comments
	Promotion of development of house price indices	Cross-border activity	Product diversity	Consumer confidence	Consumer mobility	
Continue Eurostat project	+	+	≈/+	≈	≈	Study by Eurostat with the view to develop House Price Index to incorporate into the Harmonised Indices of Consumer Prices.

Assessment: ++ = strongly positive; + = positive; – – = strongly negative; – = negative; ≈ = neutral/marginal; ? = uncertain

11. NON-CREDIT INSTITUTIONS AND SERVICERS

A core principle underpinning a competitive and efficiently functioning Internal Market is the freedom for companies to enter and exit a market. The European mortgage credit market faces two main challenges in this respect: who can issue mortgage loans and who can service[366] them.

11.1. Context

11.1.1. Mortgage lending

Under EU law, a credit institution is defined as 'an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account'.[367] According to this definition, mortgage loans can be issued by credit institutions, however, it is not necessary to be a credit institution to issue a mortgage loan. EU law does not therefore prevent undertakings other than credit institutions, which do not finance their business via deposits or other repayable funds from the public, from issuing mortgage credit. The authorisation and prudential supervision of these undertakings is subject to national laws and rules.

According to the information received,[368] in some Member States, such as Austria and Germany, an undertaking is already qualifying as a credit institution under national law if the undertaking is granting mortgage loans regardless of its funding strategy and is therefore subject to banking authorisation, capital requirements and supervision.[369] Finally, in some countries, such as the UK, Ireland, Sweden, Finland, Czech Republic and Cyprus, mortgage lending is not restricted to credit institutions. While in some of these countries, such as Sweden, Czech Republic and Finland, the lending business remains dominated by credit institutions, in other countries, such as the UK, non-credit institutions have established themselves as important market players.[370]

According to information provided to the Commission, while the extent to which the mortgage lenders are regulated and supervised varies considerably between Member States, all mortgage lenders tend to be at least subject to normal conduct of business rules, such as consumer or mortgage credit laws.

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366 Mortgage servicing comprises the 'day to day' administration and management of mortgage loans from their inception to final payment. Administration includes calculation and collection of monthly principal and interest payments, maintaining bank accounts in securitisation transactions, paying taxes and insurance premiums and taking steps to collect overdue payments including foreclosure. For further information, see footnote 171, p. 62.

367 Article 4(1) of Directive 2006/48/EC, 14.6.2006.

368 All information on the situation in Member States is taken from contributions from members of the Government Expert Group on Mortgage Credit. See http://ec.europa.eu/internal_market/finservices-retail/home-loans/gegmc_comments_en.htm.

369 In Germany, insurance companies are also permitted to grant loans. Insurance companies are subject to a prudential regime.

370 For instance, GMAC-RFC and GE Money.

11.1.2. Servicing

Servicers play a role in linking primary and secondary mortgage markets. They allow for the unbundling of the origination, servicing and funding of mortgages so that mortgage lenders can focus on their core competencies.

In Europe, the majority of residential mortgage loans are funded 'on balance sheet'. Consequently, the servicing of mortgage portfolios is predominantly carried out by the original mortgage lender. Over the last ten years, the rise in 'off balance sheet' funding (such as RMBS) has given rise to the out-sourcing of the loan servicing functions to third party mortgage service providers. These companies provide 'end to end' loan administration functions to the legal or economic owners of the mortgages.

While in the majority of Member States servicers are not subject to any banking license requirement, servicers need, according to information provided to the Commission, at least in Poland a banking license to operate.[371]

11.2. Problem description

11.2.1. Non-credit institutions

Non-credit institutions, which are allowed to offer mortgage loans in one Member State, would not be able to do so in Member States where it is required to be a credit institution in order to grant mortgage loans unless they become a credit institution. For instance, non-credit institutions like GMAC-RFC and GE Money are required to get a banking license in countries such as Austria and Germany[372] if they want to operate as mortgage lenders. This imposes additional costs for non-credit institutions engaging in cross border business compared to credit institutions which profit from the passporting regime when going cross-border. The additional costs might deter non-credit institutions from offering their products in such markets, therefore limiting product choice for consumer or excluding consumers from access to credit. At the same time, regulatory prudential and financial stability interests have to be taken into account. Those interests have to be carefully balanced with the interest of non-credit institutions to passport into other Member States. In addition, a passporting regime for non-credit institutions could potentially lead to an uneven level playing field between non-credit institutions and credit institutions due to different regulatory and supervisory requirements.

11.2.2. Servicing

Servicers who do not hold a banking license could not operate in Member States where such a license is required. The requirement to obtain a banking license imposes additional costs for servicers who wish to establish themselves in another Member States, therefore acting as a barrier to cross-border business and imposing higher costs on mortgage lenders intending to unbundled the mortgage chain by outsourcing the servicing of loans to pan-European servicers. In the end, this translates into higher costs for consumers for a mortgage loan product. As said above, any possibility for servicers to operate in other Member States

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371 Based on confidential information provided to the Commission.

372 GMAC-RFC and GE Money are offering credit in Germany exclusively via the GMAC-RFC Bank GmbH (http://www.gmacrfc.de/) and GE Money Bank GmbH (http://www.gemoneybank.de/) respectively.

without any banking licence would however have to be carefully balanced with regulatory prudential and financial stability interests.

Table 74: Problems and consequences

Problem? (▪ reasons)	Consequences
Requirement in some countries to become a credit institution in order to engage in mortgage lending or servicing ▪ Different legal requirements for mortgage lenders and servicers in Member States ▪ No passport for non-credit institutions and servicers	For consumers: – Limited consumer choice – Restricted access to mortgage products for certain borrowers For non-credit institutions and servicers: – Need to get a licence => otherwise prevented from cross-border sale of mortgage products => limited scope for economies of scale =>higher costs.

11.3. Stakeholder's views

11.3.1. Consumers

Consumers are fully supportive of expanding the number of mortgage lenders by enabling non-credit institutions to enter the market. They argue that it would improve competition in the market and thus choice and price for consumers.[373]

11.3.2. Mortgage lenders

Mortgage lenders are mixed in their views as to whether non-credit institutions should be able to provide mortgage loans, however a small majority are in favour.[374] In addition, some industry representatives are of the opinion that non-credit institutions authorised in one EU Member State to provide mortgage loans, should be automatically authorised to do the same in all other EU Member States, subject to minimum notification or registration requirements.[375] They argue that the Commission should examine creating a 'passport' for such undertakings. Other mortgage lenders, while supporting a possible 'passport', emphasize the need for a level playing field for all mortgage lenders in terms of regulation, registration and supervision (same business, same risks, and same rules).[376]

11.3.3. Member States

Member States are also mixed in their opinion on this issue.[377] Those most supportive of allowing non-credit institutions to be active in mortgage lending generally already have such an option within their territory. Member States in favour also emphasise that if non-credit institutions were to be allowed, it must be ensured that they are substantially regulated and

373 Cf. footnote 35, p. 49.
374 Cf. footnote 35, p. 49.
375 Cf. footnote 171, p. 7.
376 *Feedback on comments received on reports of the Mortgage Funding Expert Group and Mortgage Industry and Consumer Dialogue*, 26.11.2007, p. 9, http://ec.europa.eu/internal_market/finservices-retail/docs/home-loans/feedback_summary-mfeg_miceg_en.pdf.
377 Cf. footnote 35, p. 49.

supervised. The need for appropriate regulation and supervision is also cited by those Member States which are against enabling mortgage lending by non-credit institutions. Some of those Member States also state the need to ensure long term continuity in mortgage provision, which can be best ensure by credit institutions.

11.4. Objectives

In principle, the Commission favours measures to facilitate:

- cross-border activity by mortgage lenders who are not credit institutions without compromising financial stability and effective supervision;

- the use of servicers as a means of facilitating the disintermediation of the mortgage funding chain without compromising financial stability and effective supervision.

11.5. Description of options

11.5.1. Option 1: Further analysis

Before any action is undertaken further work needs to be undertaken to fully understand the scale and the scope of these problems.

The Commission has already announced its intention to publish a study in 2008 on the regulation and supervision of non-credit institutions that provide mortgage credit.[378] The study will also examine the size of the market and to what extent these institutions are active on a cross-border basis. On the basis of this information, the Commission will then decide if and to what extent future measures are necessary vis-à-vis non-credit institutions.

[378] COM(2007) 226, 30.4.2007, p. 10.