Housing Finance and Regulation: Ireland in Euroland

by Pat O'Reilly

SUMMARY

The Euro signals major change right across European Union markets presenting opportunities to E.U. citizens and challenges to E.U. financial institutions. Housing is high on the social, political and economic agenda in each member state. The housing sector is far from being a single market but is one of the sectors where the E.U. Commission is seeking to demonstrate the benefit of the single market, now driven by the single currency, to the citizens of Europe.

The Irish financial sector experienced dramatic changes in interest rates and in the composition of spreads as wholesale rates converged on the Euro over the past year. These changes and the nature of the transition are not fully understood by customers, least of all by elderly savers unable to cope with lower interest rates. United Kingdom institutions can expect similar challenges as Sterling rates converge on the Euro. This process may already be under way.

The U.K. and Irish housing finance sectors have real opportunities to broaden their funding base as European and United States bond markets compete to supply finance. This will hasten E.U. convergence on the funding side. Cross-border lending opportunities, driven by the single currency, will emerge but, with legal, tax and usage obstacles, progress will be slow.

The E.U. Commission may seek to inject pace into the convergence process, in the lending market, by bringing forward a range of measures designed to surmount at least some of the non-tariff barriers erected by many countries under the flag of the "general good."

Full convergence to a single market in housing finance may take time but is being driven by inexorable competitive, economic and regulatory forces.

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DIVERSE E.U. HOUSING MARKETS

Despite years of single-market rhetoric and regulation, E.U. housing markets are characterized more by diversity than similarity.

Different legal systems mean different product characteristics and different lending procedures and rights. For example, fixed-rate loans cannot be prepaid in Germany but may be prepaid, with penalty, elsewhere. Variable-rate loans can be prepaid with penalty in the U.K., but Irish law disallows a prepayment penalty.[1] Variable interest rates must be indexed in Spain, Portugal and Belgium, while in other countries interest rates are set by lenders in competition with each other.

Different rules and traditions for the transfer of title and registration of contracts and ownership make for quite dissimilar procedure and documentation so that, in practice, only lending practitioners and lawyers expert in local law and process can transact business.

Different tax systems give rise to different house purchase and mortgage costs, ranging from as much as 20% in Greece to 2% in the U.K. (See Figure 1.)

Much as the E.U. may aim for economic convergence, the reality has been marked differences across E.U. economies. We have had the U.K. boom and recession of the early 1990s contrasting with steady growth and price stability in Germany. The preparation for and introduction of the single currency has, of course, recently reduced high interest rates and inflation in most European economies. However, it remains to be seen whether convergence will emerge in a single currency system. Germany and its immediate neighbors are now near recession, while other countries are growing, most notably

Figure 1. Diverse Tax Systems = Diverse Purchase Costs

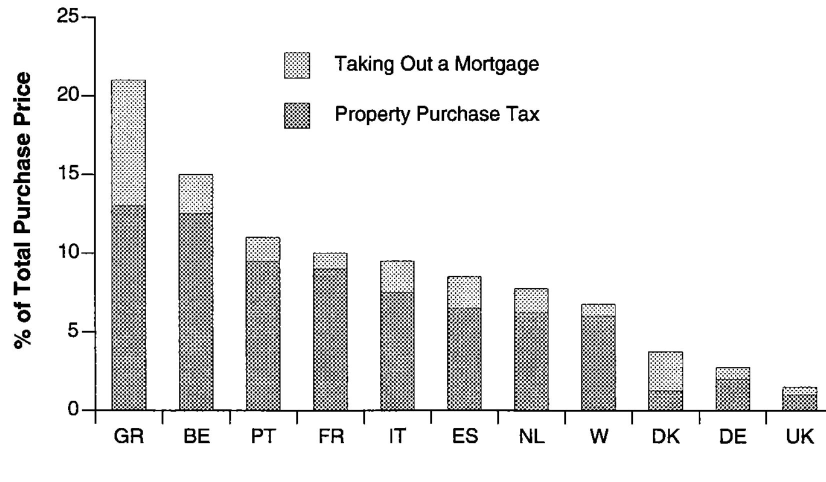
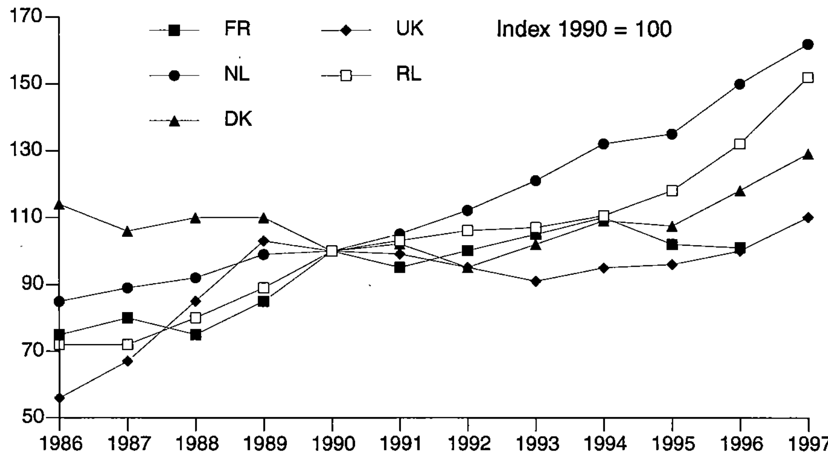


Figure 2. Diverse House Prices



NL sustained boom - scarce housing + generous tax treatment
IRL recent boom - growing employment + scarce sites

Ireland, which is currently booming with GNP growing at .8% per annum and house prices rising at 20% per annum.

E.U. house prices over the past 10 years reflect the economic diversity, as seen in Figure 2.

Prices in the Netherlands lead the group (1997), pushed ahead by scarce housing supply and generous tax treatment of home-ownership. Prices in Ireland are now (1999), most probably, well ahead of the group and are supported by a rising young population, growing employment and immigration combined with a scarcity of housing, particularly in the Dublin region.

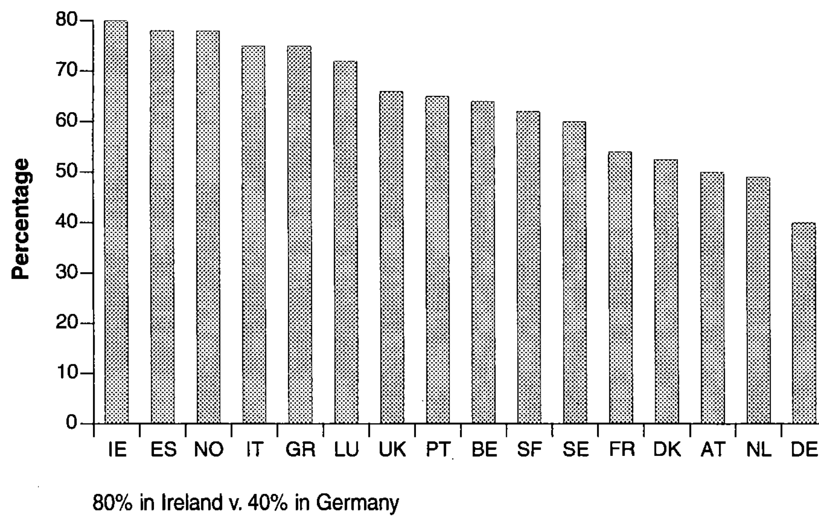
Add to these differences the diverse European cultures relating to ownership, rental and tenure, and we get major differences across the E.U. Figure 3 shows homeownership ranging from 80% in Ireland to 40% in Germany.

Strong political and fiscal support for housing and ready availability of finance have driven up homeownership levels in Ireland. Ireland's history of landlord oppression of tenants and rent controls would also have been a factor in earlier years. In contrast, mainland E.U. countries such as Germany have developed, over many years, traditions, laws and structures enhancing confidence in rental tenure and resulting in lower home-ownership levels.

Outstanding mortgage debt as a percentage of GDP is just as diverse as the ownership pattern but does not correlate with ownership levels. For example, there are quite low levels of debt in high-ownership countries like Ireland, Spain and Italy (see Figure 4).

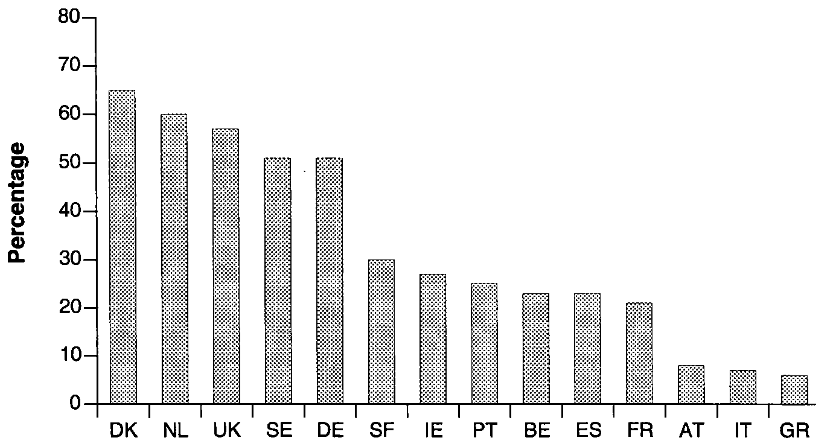
The structure of the E.U. housing finance sector reflects all the diversity of the housing market itself. Housing finance providers

Figure 3. Diverse Levels of Owner Occupation



80% in Ireland v. 40% in Germany

Figure 4. Residential Mortgage Loans as % of GDP in 1996



developed with the E.U. housing market. The housing finance sectors in each country have shaped the market and were in turn shaped by market development and regulation.

Until the advent of deregulation in the 1980s, housing finance providers were mostly specialists; indeed, this is still largely the case in some of the less deregulated economies of the E.U., such as Germany. The U.K., having led the way in deregulation, now has a housing finance market serviced by specialist (building society and mortgage bank), generalist (commercial bank) and new entrants, all competing to the benefit of consumers.

Other member states generally lag U.K. levels of competition in the housing finance sector.

The E.U. does not have a single housing market; indeed, it does not have regional markets as is the case in the U.S., but rather a collection of national markets as diverse as the cultures and languages of the people themselves. Neither does the E.U. have a single housing finance market but rather a collection of national housing finance sectors at different stages of development, efficiency and competitive ability.

IS CONVERGENCE OF EURO HOUSING FINANCE MARKETS COMING?

If the prospect of a single housing market is distant, is a single E.U. housing finance market foreseeable?

This is a subject exciting considerable interest at the E.U. level. The advent of the Euro, having raised expectations, is perceived to have delivered little value to consumers other than lower interest rates in some countries. To those driving the single market project, housing finance must be an attractive area to force convergence and demonstrate

how citizens are to benefit from a single market in financial services.

There are also other, more powerful, drivers which will over time force convergence in the Euro housing finance markets.

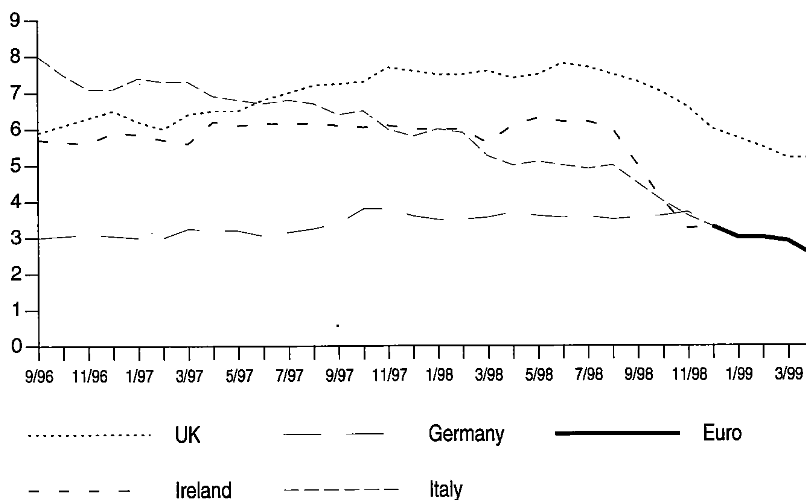
The Euro single currency is the most potent force; already market interest rates have converged in Euroland (see Figure 5).

Despite the market interest rate convergence shown in Figure 5, there remain significant differences in mortgage rates in different member states. Mortgage interest rate convergence has not yet translated across Euroland.

A number of observations can be made:

- The fact that wholesale money markets have converged in Euroland does not mean that the funding costs of lenders have converged; this process has just commenced.
- There remains significant diversity in the mix and cost of funding sources in Euroland.
- There are significant demand and supply differences in different markets affecting property and credit prices.
- Retail savings interest rates in the U.K. and especially in Ireland remain relatively high in relation to wholesale market rates, forcing institutions to recoup margin disproportionately on the lending side of the book.
- U.K. and Irish consumers on the savings side, although now getting low returns, are still gaining at the expense of borrowers.[2]
- Two-tier U.K. mortgage rates mean that new borrowers are gaining at the expense of existing borrowers.

Figure 5. Market Interest Rate Convergence



Whatever the causes of delayed convergence, most likely a mixture of the above, it is inevitable that there will be significant further convergence of mortgage and savings interest rates across Euroland. It is in its early days yet, and interest rates and margins have not settled into what will be the long-term pattern forced by economic convergence, competition and regulation.

Euro Capital Markets will be a major driving force toward convergence. Availability of funding and competition will provide lenders with the incentive to seek out high margin markets and to cross the competitive barriers in doing so.

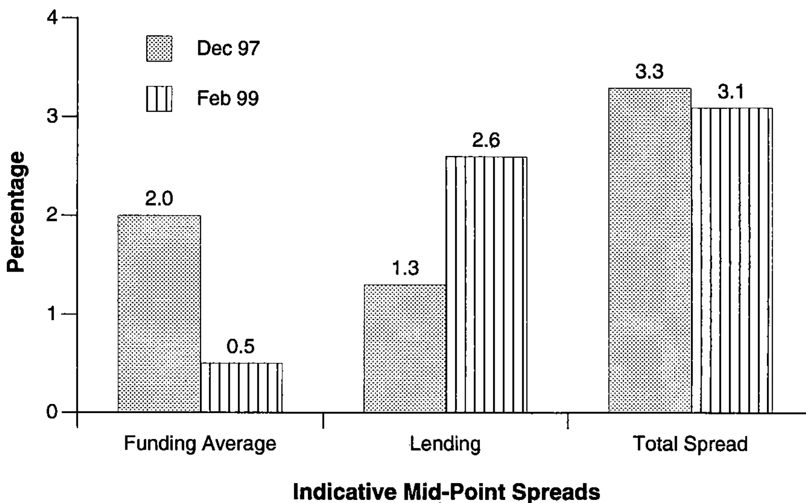
This process will be hastened by cross-border consolidation and rationalization in the financial sector generally. These developments are now well underway in the U.K. and elsewhere and, over time, the market may become dominated by the large players, with only the most efficient smaller regional providers surviving.

How long the process will take is hard to say. Certainly, current non-tariff barriers are real, and there has been little success to date in cross-border competition in housing finance. Perhaps the pump may be further primed by E.U. regulation, forcing countries into a minimum harmonization and mutual recognition regime for some housing finance products. This is certainly what Brussels would wish to achieve, and this will be discussed under the heading of regulation.

EURO IMPACT: THE IRISH MARKET

The Irish market is coming through a period of dramatic change as converged Euro wholesale rates and other forces impact on retail markets and institutions. These changes

Figure 6. Irish Market Spreads vs. 3M Euribor Funding, Lending and Total Spread



affect both the price and volume of funds and involve both sides of the balance sheet.

Figure 6 gives an indicative picture of the dramatic changes in Irish interest rates and margins driven by the Euro convergence process over the past 18 months.

Funding spreads have fallen from around 2% to 0.5% currently and may fall further. Lending spreads have doubled to compensate. Total funding/lending spreads have fallen somewhat but remain high at over 3% ranging from just over 2% (EBS) to about 3.5% (Clearing Banks). These spreads compare with U.K. spreads ranging from 1% for new entrants to 3.5% for larger banks.

Interest rate convergence has seen Irish mortgage rates fall from over 8% five years ago to 5% today, and the process is by no means over:

- Current lending rates and spreads are likely to reduce or be reduced by competition.
- Before this happens it is possible that a further decrease in Euro rates will reduce spreads by forcing mortgage rate cuts without compensating savings rate reductions. Most administered retail savings rates have by now hit the buffers.

Retail funding has been the traditional and remains the dominant source of mortgage finance in the Irish market. Forces reducing the proportion of retail funding in the housing finance mix are:

- The savings ratio is in decline as consumers dispose of more of their income on lifestyle and consumer durables.
- Low nominal interest rates encourage investment in alternatives to savings. These include managed funds, insurance bonds, pensions and property.
- Strong loan demand has outstripped flagging deposit growth.
- Competition for the remaining savings market has intensified. It is now possible to get 1% and more above wholesale market rates for retail funds.

The Irish experience is relevant to the U.K. market where interest rates have some way to go (about 2.7%) to converge with Euro rates. As has been the experience in Ireland, U.K. administered rates will soon get near bottom. Intense competition from other players in the savings market will make it difficult to pass on rate reductions. In these circumstances margins can only be preserved by increasing lending spreads. Indeed, there are some signs that this process has already begun.

What makes this transition difficult is the implicit assumption, particularly in the media, that lower rates are a good thing. Borrowers, encouraged by media "Euro" articles, want low Euro mortgage rates, around 3.5%, and do not appreciate "margin widening" exercises by their lender. Meanwhile savers cannot understand why their society cannot continue last year's 7% high yield account.

FUNDING IN EUROLAND

Converged interest rates, the absence of exchange risk and the existence of well-developed, deep and liquid debt markets in Euroland will transform the funding model for housing finance across the E.U.

This has particular application to the Irish and U.K. markets where the existing model of financing long-term assets by short-term liabilities may, in time, give way to a more secure system where interest rates and maturities are more closely matched.

Much as we like the model which has served well for over 100 years, we should acknowledge that, during the currency and interest rate crises of the early part of this decade,

we would all have wished for a more secure funding base. Indeed, had the funding base been more secure, the interest rate volatility of that period may largely have been avoided in the housing finance sector. Distant as these events may now seem, we should take the opportunity of insulating against crises to come by diversifying our funding to reduce interest rate and maturity risks for our institutions and our customers.

Capital Market funding which can meet the above requirements is now the dominant source of housing finance in the U.S., where over 70%[3] of mortgages are funded by mortgage-backed securities. In Europe, funding by mortgage bond issues provides around 20%[4] of mortgage credit. Germany is an extensive user of mortgage bonds, accounting for 46% of all E.U. issues. Denmark and Sweden are also substantial users of mortgage bonds. While institutions in other E.U. countries, including Ireland, have issued mortgage-backed securities, the use of mortgage bonds outside the above core countries is only commencing.

Mortgage-backed securities have for many years been established as a major source of funding for U.S. housing markets. The essentials of this financing mechanism are that the asset is sold off the balance sheet. This not only deals with the funding issue but also reduces capital requirements and credit risk. All of this has to be paid for and, sometimes, the costs involved, such as credit enhancement, are seen by lenders as too high for a component that they may not have needed in the first place.

Securitization is expensive, with costs of 0.75% to 1.0% over Euribor. Having said this, it must be acknowledged that this route is an excellent funding source and can be used to underpin the overall funding and capital strategy. Taken in isolation and allowing for the saving in capital resources, securitization can compete well with other funding sources.

While the number of transactions and the amount of funds raised so far is relatively small, most E.U. member countries have some involvement, and this source of funding will probably grow rapidly in coming years. A disadvantage is that transactions must be large in order to absorb high costs and, moreover, a debt rating is required. This could prevent smaller lenders from availing themselves of securitization.

The mortgage bond was developed in Germany and Denmark over 100 years ago. This instrument is new to U.K., Irish and other E.U. markets; it is exciting interest as a source of funding for housing markets.

Essentially, the mortgage bond is a debt instrument specifically collateralized by the assets being financed. The collateral levels are high, and the loan to value limit is usually 60%. The existence of a trustee and specific legislation enables bondholders (creditors) to be confident that transactions are completed correctly, that security is kept in place and, in the event of failure, that a prior claim to the collateral exists in favor of the bond holder.

A particularly attractive feature of the mortgage bond is that it is capable of being rated more highly than its issuer. How this may translate in practice outside the traditional heartland of mortgage bonds remains to be seen. It is likely that outside the core bond issuing countries a rating would be a prerequisite to successfully tap this new source of funding.

Mortgage bonds in Germany are typically issued for terms of up to 10 years and at fixed rates matching fixed-rate loans of longer term. Given the existence of a well-developed, deep and liquid market, this is an attractive funding source for Irish and U.K. lenders.

Special legislation is required to regulate priorities and permit institutions to engage in this funding. Already in recent months a Spanish bank has completed its first mortgage bond issue at an attractive price (slightly above the cost of 3 M Euribor) and mortgage bond legislation is on its way to the statute book in France and other countries. Work is underway in Ireland to formulate a proposal for legislation to facilitate the entry of Irish institutions to this market.

The opportunity to diversify funding sources to include mortgage bonds is an important benefit of the single currency. It is likely that this source will be extensively tapped across the E.U. in coming years.

HOUSING FINANCE REGULATION

There are three sides to this coin:

1. Consumers are ever more demanding and see in the E.U. the prospect of cheaper financial services, particularly mortgages. This process is pushed by media reporting of lower cost mortgage products from other countries. At the E.U. level, consumer lobbies have the financial services sector in their sights and, assured of popular and political support, can apply real pressure on the E.U. Commission.

2. Many lending institutions, even those interested in new E.U. funding opportunities, may not see a single market in housing finance as a compelling priority. Coping with increasing local regulation, strong local competition, lower margins and the ever rising expectations of consumers may seem more than a sufficient challenge. Indeed some lenders will want to preserve local regulation as a non-tariff barrier to cross-border competition.

3. The E.U. Commission may see the housing finance market as a case of "weakness in diversity." There is a real dilemma here. If housing finance markets are "left

to their own devices," the diversity discussed earlier will continue, and convergence to benefit consumers may be long deferred. However, if market convergence is forced, other problems are inevitable, such as:

- Regulatory and legal harmonization would reduce product diversity and retard innovative development to the detriment of customers, with the likely beneficiaries being the large and less innovative institutions.

- Consolidation of the housing finance sector into the hands of a small number of global/multinational financial institutions would not necessarily be in the interests of consumers. Global financial institutions have a poor track record in serving retail customers. Competition would, of course, continue but with less choice and possibly at higher margins than would otherwise obtain in a market supplied by a larger number of diverse institutions more closely identified with their customers.

The urgent need to show progress in the development of the single market and how consumers may benefit is likely to ensure that the E.U. Commission will take regulatory action of some kind. Lenders may have an opportunity to gain a measure of influence by engaging in the process. Although slow to become involved, lenders have made some limited progress toward self-regulation.

The European Mortgage Federation, representing mortgage lenders in 16 European countries, including the Building Societies Association (BSA) and Council of Mortgage Lenders (CML) in the U.K., is a major participant in this process at the E.U. level. The EMF has in recent times been engaged in detailed discussions with the E.U. Commission, E.U. consumer groups and other financial sector federations such as the European Bankers Federation, the Savings Banks and the Bausparkassen.

Currently, the major agenda issue is agreement on a voluntary Code of Conduct that would apply to lenders and intermediaries. This code is primarily concerned with providing consumers with information which would enable them to compare mortgage products from different providers in different E.U. countries. The code also undertakes that lenders will act fairly and reasonably toward their customers at all times.

The specific information promised in the code to assist comparison of products includes:

- APRC, fees, costs, interest rates and penalties.

- Valuation, insurance and prepayment.

- Tax relief and subsidies.

- Procedures for complaints, cooling-off period and the applicable law.

- A single-page information sheet (SPIS) summarizing the main contract terms.

There is as yet no final agreement on all of the above issues. Indeed, the Savings Banks and the Bausparkassen seem reluctant participants and have particular objection to the SPIS. The Consumers Association is also reluctant to proceed, believing that without the SPIS the code would be of little practical use to consumers.

At this stage the Commission is anxious that negotiations proceed and that a code be agreed upon by September 2000. This position is supported by EMF and the Bankers Federation. There is nothing in the code that should concern lenders in countries that already have mortgage finance regulation. This includes Ireland and may soon include the U.K. Indeed, much of what the code contains is little more than good customer practice; its value is more as a vehicle to get a dialogue going than a means by which lenders are making any real concessions to consumers.

A FEW PREDICTIONS

One can only speculate about the outcome, but here are some thoughts:

- The code will be agreed upon and implemented by most but not all lenders across the E.U. Content will be augmented over time on a voluntary basis, and eventually virtually all lenders will be included; or,

- The code will be implemented more or less as above and at a later stage, if progress is not sufficient, it will be used as a basis for E.U. legislation and regulation; or,

- The code will remain bogged down in the negotiation process and be overtaken in the short term by E.U. legislation, some of which may be on the way in any event.

It is quite difficult to predict the outcome at this stage. E.U. legislation would be difficult to frame and implement in countries where existing and planned regulation (U.K.) is more or less restrictive.

The first outcome is the one sought by EMF, but it is an uphill struggle.

The second outcome would not be as bad as it might appear in that the industry would have an excellent opportunity for dialogue over time with consumers and regulators; this would make for a better and more workable solution all around.

The third outcome is fraught with danger for lenders. New regulation introduced in these circumstances would be without the benefit of real dialogue. Lenders would be seen as having refused to co-operate, and consumer-biased regulation would most likely result.

Legislation could include:

- E.U.-wide APRC, giving most member states two APRCs.
- Indexing of variable-rate loans.
- Legal prepayment rights and penalty limits.

For good measure, E.U. legislation/regulation is, or will shortly be, underway in the following areas:

- Distance selling and e-commerce.
- VAT and money laundering.
- Prudential measures including capital adequacy.

Whatever the likelihood of E.U. regulation along the above lines, there may well emerge specific provisions to enable cross-border competition in the provision of mortgage finance. This could be attempted by a partial harmonization of one or more mortgage products and E.U. legislation which would enable cross-border lenders to avoid particular local "consumer protection" or "general good" laws or regulations.

CONCLUSION

However it may happen, it is inevitable that coming years will see the considerable convergence of E.U. mortgage finance markets. The economic conditions are there, and, with the single currency, the financial conditions are in place. Laws, regulations, business usage and social conditions remain diverse, but Brussels is working on it and may well come up with a result if not a solution.

Convergence, inevitably, sooner or later will bring:

- More direct lenders and cross-border selling of mortgages.
- Lower mortgage rates and lower lending margins.
- Cannibalization of existing higher margin mortgage portfolios.
- Consolidation of the industry into large scale operators.
- Survival of only highly efficient smaller regional players.

Clearly, consumers, particularly the more sophisticated and financially better off, will benefit. A major downside could arise from the increased distance between lender and borrower. Already issues are arising in local markets where customers have been misled, mis-sold or not informed of the realities of the most important transaction of their lives. In the current Irish boom conditions, for example, there is a real fear that excessive lending will generate overindebtedness problems in years to come. Any new E.U. dispensation will have to provide for this dimension; otherwise the benefits for some consumers will be outweighed by the disadvantages to others.

NOTES

[1] For variable rate loans only.

[2] However, savings customers, having seen rates fall rapidly, perceive that their returns are unreasonably low.

[3] A. Pollock, *Housing Finance International,* March 1999.

[4] A. Houmann, February 1999.