Developments in Europe

By Peter Birch

I t is important to ask why specialist lenders should concern themselves with Europe. I believe there are four main reasons.

(a) Competition in the UK is such that we have many European-based institutions competing on equal terms in the mortgage market. Some of the more recent additions are French, such as UCB (providing mortgage finance through Prudential Insurance); Credit Agricole (through M & G); Societe Generale (through the Skipton Building Society); and Banque Nationale de Paris (through acquiring the mortgage subsidiary of Chemical Bank). Some of these entrants to the UK market have provided services with a lower rate of interest, or more generous status requirements, than the UK-based distributor has been offering. It is therefore worthwhile looking at the home markets of some of these institutions to see if the battle cannot be carried forward into their own territory.

(b) Looking at housing tenure statistics, there are markets in Europe where home ownership is not nearly as well developed as it is in the UK. A simple analysis suggests that there are opportunities for selling mortgages in these markets.

(c) For UK-based institutions such as building societies, involvement in Europe gives any such lender the opportunity to spread its risk across more than one market.

(d) Also, there is the scheduled opening of the EC market in 1992. This would mean that UK mortgage providers should (if the objective of the 1992 single market is followed to its logical conclusion) be thinking much more in terms of a market with more than 300 million potential customers, instead of the 60 million in the UK. Looking at it another way, a major UK mortgage provider post-1992 could well become no more than a large regional institution in part of Europe.

Building societies have come fairly late to the opportunities offered in other member states of the EC. This is because legislative restrictions have only been lifted since January 1988 to allow these institutions to operate in Europe. It is worth remembering, and perhaps this is a fifth reason for further concentration on Europe by UK building societies, that Europe is the only market opened up to societies by these changes in controlling legislation; markets elsewhere in the world remain closed to UK building societies.

Having said that, the major UK clearing banks, which have not experienced such legal restraints, have made slow progress in entering the retail markets in Europe so far, with the one exception of Spain, whilst at the same time they have had no competition from their home base to date.

It has clearly been difficult for the banks to penetrate these markets and so it can be argued that it will be equally difficult for specialist lenders. I suspect, however, that until recently, the banks have not considered the retail market particularly worthwhile in Europe. In addition, despite all the talk of 1992, it is still true that housing finance institutions have to deal with peculiarly national markets, where very different conditions exist in individual member states.

Unlike banking, where chequing accounts, personal loans and credit cards are basically similar everywhere, housing finance systems are much more idiosyncratic. In the European market we find different tax regimes, capital gains taxation on house transfers, larger rented sectors than in the UK and higher levels of regulation in systems as in Germany and France.

Home ownership trends in Europe

A simple analysis of housing tenure statistics for Europe could suggest that there are opportunities for selling mortgage products in these markets where owner-occupation is at a lower level. In fact, the picture is less straightforward. The availability of rented accommodation plays a significant role in determining the level of owner-occupation in a market, together with the level of prosperity for the country in question. The figures here tend to suggest that the more prosperous a country, the more important the rented sector will be, with a correspondingly lower level of home ownership.

As an example of this, Switzerland has an owner-occupation level of only 30%, whilst in West Germany the level is some 40%. This theme should not be taken too far, however, as looking at levels of owner-occupation on their own can prove to be misleading. Switzerland, despite having a low level of owner-occupation, has one of the higher levels of outstanding mortgage debt.

In the UK, the privately rented sector is much less significant than in most of the other European countries. Thus we see that the privately rented sector in the UK accounts for only some 12% of the market. By comparison, in France the figure is 26%, in Belgium it is 31% and in...
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In addition, some member states of Europe are under political and economic pressure to maintain housing construction programmes whilst, at the same time, they find themselves increasingly unable to fund such programmes. There is no doubt that this situation creates opportunities for mortgage lending not necessarily indigenous to these individual markets.

An example of this is West Germany, where it is official government policy to encourage and increase the level of owner-occupation, with a target of 50% ownership — a substantial increase on the present low level of 40%.

In Spain, the government attaches particular importance to housing construction and has gone out of its way in recent years to encourage more liberal means of housing finance. Hence its decision in 1982 to allow the setting up of mortgage loan companies, under more generous banking co-efficient than those applicable to the banks themselves.

The 1992 target date is also offering prospects in other markets, to those institutions in states which have enjoyed a closed market. It is therefore encouraging these states, of necessity, to open up their own markets to foreign competition.

Differences by country

At this stage I would like to look at some of the reasons why the markets are so different. First, as mentioned previously, in most European countries there is a much larger privately rented sector than in the UK.

Secondly, house prices in other member states of the Community have not enjoyed the steady increase in value that we have seen in the UK over the last decade. Whilst, during the early 1980s, the UK suffered the same economic problems as other EC countries, namely sharp increases in mortgage interest rates, high unemployment and general uncertainty over job prospects, other countries did not enjoy the generous tax relief on mortgage interest, absence of capital gains tax on house sales and social security payments that covered mortgage interest repayments which were available in Britain.

Because of this, any British institution looking at the European markets must do so understanding that they are much more volatile markets, where home ownership is not seen as the safe investment it is in the UK and where it is not given quite the high priority that borrowers tend to give it in this country.

It is also worth noting in Europe generally the costs of acquiring a home are more substantial than they are in the UK. In Belgium, legal costs are some 17% of the value of the home whilst the European average is between 7% and 8%, compared with some 2.7% in the UK.

It is also significant to note that in Belgium a family will probably move three times in its life — initially to rent a flat when husband and wife are married, thereafter to buy a family house when they have children, and lastly to sell that and buy a smaller house when they retire. That does not provide institutions with the average mortgage life of five or six years that we see in the UK. With capital gains tax payable on each transaction in Belgium, plus VAT of some 16% on the acquisition of a new house, one can begin to see that some of the European markets are not particularly attractive.

Having offered a fairly cautionary picture on the reality of some European markets, it is also worth recalling the extent to which state intervention encroaches on housing finance compared with the UK. This can be found in two areas, first in housing markets and secondly in the financial markets.

In France, for instance, not only would a mortgage lender find itself competing against some of the state institutions such as Crédit Foncier and the Caisse Nationale d’Epargne, but also with the major banking groups, a number of which are still nationalised. That does not take into account Crédit Agricole, which claims to be one of the largest banks in the world. In France alone it has some 5,600 branches and a substantial share of the domestic mortgage market. France also provides further obstacles in the shape of controls on the rates of interest for savings products and on the ability of an institution to raise money on the wholesale markets.

Similarly, in Belgium, whilst there is not exactly control of interest rates, the central bank provides "guidance" on interest rates being offered on deposits and there is still doubt in Belgium as to the legality of charging a variable interest rate on mortgages.

In West Germany only the Bauspar kassen, which are somewhat similar to UK building societies, enjoy special tax advantages attached to their form of operation. This gives them an advantage in the market that would be difficult to match for any newcomer.

The room to manoeuvre provided for an institution, and more particularly for any new foreign entrant into some of the European markets, is therefore considerably lower than is the case for, say, a new foreign entrant into the UK, where for nearly a decade institutions, particularly building societies, have been facing strong competition in their home market.

Implications of 1992

Undoubtedly the opportunities in those markets would be made a lot easier if some of the predictions being made for 1992 were to come true. It is therefore perhaps worth looking at this stage at what that magic date could mean for UK mortgage players.

In essence, what these three pieces of legislation mean if enacted is that if an institution is authorised to operate in its home member state, then that is evidence to a host state that an institution is a fit and proper one to conduct or establish its business there and, in effect, institutions will have a single licence applicable across the EC. This would, of course, be very significant to banks from countries outside the EC established in one of the member states.

The mortgage credit legislation aims to abolish obstacles faced by specialist mortgage institutions in undertaking mortgage business throughout the Community. I have some doubts about whether this directive will ever be agreed, since what it originally aimed to achieve was to allow import of foreign funding techniques into host states.

So, for instance, a UK institution would be able to set up in, say, France or West Germany and demand of the authorities there that as the institution intends to operate a variable rate mortgage (which works in the UK with the flexibility of funding in retail and wholesale markets), then the authorities in the host state should provide conditions similar to those prevailing in the UK. To my mind that seems unlikely and this directive, having been in existence since 1984, is now being amended and could be under discussion into the 1990s.

The mortgage bond directive will operate on a system of mutual recognition for such bonds issued in individual member states. This would be a useful piece of legislation in allowing for greater flexibility in funding and may well become legislation before the mortgage credit directive.

However, I note recent fears expressed in the German mortgage market over the idea of mutual recognition of mortgage bonds. The Germans claim that their mortgage backed securities are superior in quality to those elsewhere and that the opening of the market could threaten the existence of the German mortgage banks.

I think that there is little doubt that the second banking directive will come into force and will assist institutions wishing to set up retail operations in other member states. Perhaps the most important element of the 1992 target at present is not the speed with which matters go forward in Brussels, nor the fact that we may be talking about 1995 or 1997 before much of this legislation becomes law, but that a majority of member states and most institutions are already seeing 1992 as a cut-off date. In effect, they expect, prior to that date, to have completed or be near completing whatever strategy they have for what will become a common European market.

Hence the wide-ranging activity we are seeing in the French insurance market in terms of takeovers and defensive alliances. Likewise the moves we are seeing between Spanish and French banks and the recent alliances between the Dutch Amro and Belgian Generale bank, and the Royal Bank of Scotland and Banco Santander. Cross-border alliances seem set to continue and to increase in pace over the next four years as specialist lenders also start to form alliances, as one sees with the French savings banks and Caixa de Barcelona, the biggest Spanish savings bank.

Nevertheless, the financial restrictions that exist in many member states do constitute a real brake on opening the market. For example, exchange control restrictions on financing long and medium term loans at fixed rates in Italy, Spain and Portugal. Further, the special rights accorded to the West German mortgage banks on marketing mortgage bonds and the control on retail deposits in France all inhibit entry by foreign specialist institutions.
Likely trends

Without a doubt, the Second Banking Directive and the Directive on Mortgage Bonds, if drafted widely enough, will go some way to removing or at least easing some of these obstacles; but the fear must remain as to whether these legislative proposals will move fast enough to make a real difference.

The difficulties of penetrating the European market for the specialist lenders can be contrasted with the way in which the UK banks have developed their presence in Europe. The UK banks have concentrated on serving corporate customers through the wholesale markets. They have not attempted, in general, to tackle the local retail markets in the EC which require the establishment of extensive branch networks.

Not only can corporate and wholesale banking operations work from a comparatively lower number of offices, but, in general, the nature of the business attracts less restrictions than a retail savings or housing finance operation would.

Furthermore, banks will open an office specifically to serve some of their home base customers that have already moved to the country in question. In addition, banks may be able to serve some European-based companies with whom they are already doing business at home.

As stated earlier, there are a few examples of foreign banks which have developed a retail presence. Chief among those which have are Citibank and Barclays. In both cases they have done this through acquisitions.

Impact on major lenders

Prospects in Europe are therefore mixed. I am, of course, not going to point to individual member states where the markets offer opportunities for housing finance institutions. I would not seek for a moment to argue that any mortgage lender is going to find a vast market out there in Europe.

However, for the large and small specialist lender there are niche market opportunities where borrowers have been restricted in their choice of mortgage products over the years. Those markets need to be carefully researched as to method of distribution, type of product, marketing strategy and, of course, profitability.

It is essential to understand the local market and the problems associated with it. The present EC legislation is going to create opportunities but the most that legislation can do is to remove some of the more intractable legal and regulatory obstacles to a new institution operating in an EC market. If Community legislation is to make any progress in the European housing finance market, it would therefore be in overcoming these obstacles.

With a population of some 300 million plus, 50% of whom are not yet owner-occupiers, the potential in the common market is considerable and specialist institutions in the Community are being presented with a very real market opportunity.

In the past few years there has been a change in the attitudes of some governments in member states towards their financial markets and the movement of capital across frontiers. States that were regarded as closed to outside specialist institutions are beginning to change. Lenders will inevitably move towards the most attractive markets for housing finance.

If an institution is to attempt to penetrate some of the continental European markets and establish a local presence, then it faces two main options as to how this may be achieved: the acquisition of an existing operator or the start-up of a completely new operation.

With acquisitions, new entrants have faced a number of problems.

At this time, institutions looking to make an acquisition are coming to the market relatively late in the day. Over the past few years many of the smaller independent institutions have already been taken over by larger groups. Further, a number of the more attractive targets in Europe, such as the savings banks, are public in the sense of being owned by the state or by their regional governments. They are not, therefore, available for acquisition.

For building societies, still working within the limitations of restrictive legislation, many of the activities at present being carried on by some of these possible acquisition targets are outside the powers allowed to building societies, even when operating in Europe. Further, what is available for acquisition is very often not worth buying. Local supervisors can sometimes add to this picture by making the price of entry into their market the acquisition of the most troubled institution in their state.

Institutions choosing the second method of entry, the start-up of a new operation, can face serious limitations placed by national supervisory authorities on the opening of offices, and as I mentioned earlier, on the means of funding. It is often the case that regulatory authorities are not prepared to grant consent for the opening of offices on the scale and at the pace necessary to allow a new operation to become profitable in a reasonable period of time.

The opportunities

At Abbey National our strategy has been more opportunistic, with our approach reflecting the need for profit and the need to gain experience and understanding of what to us are "foreign markets." To prepare for 1992 we researched the European member states thoroughly and identified those where start-up operations looked possible against the following criteria:

A relatively modest capital injection.

A welcoming attitude by the authorities.

A free market susceptible to innovation.

Wider margins than available in the UK.

The capacity to generate fee income.
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Competitors with problems. Avoidance of exchange risks (which we cannot legally accept and would not want to do prudentially anyway).

Against these criteria many European markets are, at present, not of interest. The level of regulation and state involvement combine with a low level of opportunity and attraction for the new entrant. As a generalisation, the more mature and regulated markets are in the north, whilst the more exciting prospects are in the south.

Since the societies' power to lend in Europe came into force on January 1, 1988, Abbey National has opened its doors in three locations outside the UK:

Abbey National (Overseas) Ltd based in Jersey.
Abbeycor Nacional Hipotecario in Madrid.
Abbey National (Gibraltar) Ltd in Gibraltar.

Dealing with our first venture into a major EC economy, Abbey National identified Spain as a clear-cut opportunity because:

1. The Spanish Government was deregulating the financial system relatively quickly.
2. The Spanish economy was seen as buoyant in the long term with benefits flowing from recent admission to the EC.
3. New statutes had created a new corporate format — the mortgage credit company, whose constitution fitted a UK building society's legal powers under our new act.
4. Contact with the authorities was encouraging.
5. An acquisition was not necessary.
6. Wide margins were available in the short term.

Further, the existing mortgage loan operators in many cases belonged to groups, particularly the domestic banks, whose widespread branch networks (with more branches per capita than anywhere else in Europe) gave them cost problems.

From this analysis, identifying the opportunity at the macro level, we proceeded to deal with the more difficult and complex aspect of progressing the development of this project through an implementation strategy to operations, which began in February 1988. The product of all this work was Abbeycor Nacional Hipotecario, which is a partnership of three widely different companies:

- Grupo Cor, a financial services company with some mortgage market experience, skilled management and ambitions to grow faster in the mortgage market.
- Winterthur, the Swiss insurance company, a worldwide operator

"Waiting for 1992 will be too late" with a very successful Spanish subsidiary whose management saw opportunities in the mortgage market and whose distribution network of branches and agents could support a wider product range — including mortgage products.

- Finally, Abbey National, a major UK mortgage lender, with capital, a strong credit rating and experience of a highly developed and competitive mortgage market; the majority shareholder in the new company.

For both our partners there were distinct opportunities provided by the formation of the new company. For Grupo Cor the chance to develop a bigger presence more quickly than their own resources could support. For Winterthur the chance to generate more income from their network, to sell more products along with the new mortgage product and, perhaps most interestingly, to be the supplier of the endowment policy for the endowment mortgage product for Abbeycor Nacional.

The endowment mortgage product offered by Abbeycor Nacional has been a major element in building our new company's market position as an innovative, efficient, streamlined new lender.

Conclusion

From these last comments it is clear that, despite the cautionary doom and gloom in the earlier sections of this paper, I have not been saying that there are no opportunities for mortgage lenders in Europe.

Certainly, as member states become more affluent, particularly the newly joined members, and as competition increases in some of the major EC states such as France and Germany, so potential borrowers will begin to realise that whilst their own system has remained somewhat rigid and complex, new and more flexible mortgage products have become available in other countries, particularly in the UK. Inevitably, some of these products can be marketed elsewhere in Europe and can provide niche markets for those operators willing to look for the opportunities.

It has been said by some institutions that with the advent of 1992, lending in Europe will become easier and that prospects for mortgage lenders will increase. Despite all this talk of open markets, we are a very long way from being able to market a single mortgage product across Europe. Indeed, we may probably never reach that stage and the one message I hope I have managed to convey is that we are dealing with a series of individual markets which must be approached as such.

Nevertheless, any major mortgage lender wishing to get into Europe and who is contemplating waiting for 1992 to see if things will be easier will have missed the opportunities. Our friends across the channel have not and are not going to wait.

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