Variability of mortgage rates in the EC

THE European Federation of Building Societies and the European Community Mortgage Federation have published a study of the variability of interest rates on mortgage loans in the European Community. The study was carried out by a working party comprising representatives of all of the countries of the European Community with the exception of the Republic of Ireland and Luxembourg. It was headed by Bernard Clappier of France and benefited from the assistance of the secretariat of the European Community Mortgage Federation.

The report is in the form of a general summary, followed by tables and then national reports compiled by each country on the basis of a common plan.

Categories of variable rate loans

There are three main categories of variable rate loans:

(a) Reviewable rate loans whereby the lender adjusts the rate upwards or downwards according to the cost of his resources.

(b) Renegotiable rate loans where the rate is subject to renegotiation at contractually agreed periods.

(c) Reference rate loans by which the rate is tied to another rate of interest.

Variable rate loans are permitted by law in all countries of the Community, but there is a restriction in Belgium whereby, in practice, only renegotiable rate loans can be authorised. The great majority of Community countries offer variable rate loans and this is the case almost exclusively in the United Kingdom, the Netherlands, Spain and Italy. West Germany, Belgium and, to a lesser extent, France offer their borrowers a choice between variable rate and fixed rate loans and Greece and Denmark do not offer fixed rate loans at all.

Reviewable rate loans

Reviewable rate loans predominate in the United Kingdom and West Germany. In the United Kingdom the most typical case is that of the building societies, which finance a very large share of the market. Each building society can at any time adjust the rate upwards or downwards according to its own refinancing cost. The rate can be reviewed at any time and without notice. Notification is made through the press and then generally confirmed through a personalised letter to the borrower. There is no limit on the possible range of rate variations.

Building societies take care to ensure that the new rate for existing borrowers does not exceed that in force at the time for new loans of the same kind as those made previously. In the case of very large increases in rates, borrowers have the option to extend the loan duration. However, this possibility does not exist for loans attached to life assurance policies which are very widespread in the United Kingdom.

In West Germany and the Netherlands, reviewable rate loans are available from commercial banks and savings banks. Mechanisms for calculating the new rate and its impact on the repayment amount are very similar to those of the United Kingdom, although in West Germany the variation must be objectively justified by a change in refinancing costs. The customer is notified either by his statement of account or by letter. In West Germany the lender is required to notify the borrower at least two weeks prior to the rate change taking effect.

Renegotiable rate loans

There are two kinds of renegotiable rate loans. The first kind is common in West Germany and the Netherlands and available in particular from mortgage banks. The bank grants its customers a loan for a given period, but the loan rate is agreed for an initial period only which varies from one contract to another. Generally speaking, the longer the period of commitment the higher the initial rate. As a rule, the initial period ranges from three to five years, after which time a new rate is negotiated between the lender and the borrower for a further period.

The second type of renegotiable rate loan is available in Belgium in the special form of a five-year repayability clause. As variable rate loans are not authorised under Belgian law, the supervisory body for mortgage credit banks has provided that when the loan period exceeds five years the lender has the right, at the end of the fifth year or on subsequent fifth anniversaries, to demand total or partial repayment of the loan subject to three months' notice.

The customer can either repay the loan, in which case he pays no penalty, or he can ask to retain the loan by accepting the rate conditions applying at that time. The stability of the new rate is then guaranteed for a further minimum period of five years.

Reference rate loans

Reference rate loans are the general rule in Portugal, Spain and Italy. In the case of the latter two

36 →

← 35

countries, state-subsidised loans are at a fixed rate. The various kinds of indices are all financial and are known to the customer from the outset. In Portugal, until recently, the rate variation could not have the effect of pushing the rate higher than the ceiling rate fixed by the central bank.

Loans were, in fact, always at this ceiling rate and varied each time the central bank adjusted its ceiling rate. Since March 1989, each institution is free to determine the reference index. Where loans have constant repayments the rate variation is passed on fully and immediately and, in the case of graduated repayments, the repayment amount is recalculated only once a year.

In Spain, either the rate is based on the preferential rates applied by the leading banks or savings banks or it is based on the rate on government bonds or mortgage bonds.

In Italy, various kinds of index are used, all of which are linked to the cost of loan refinancing and are generally made up of a basket of references provided for in the loan agreement. In most cases the periodicity of rate variations is half-yearly, with three months' notice prior to the half-yearly due date. Rate variations are always fully and directly reflected in the repayment amount.

There is the recent emergence of reference rate loans in the United Kingdom, the loans generally being linked to LIBOR (London Inter-Bank Offered Rate).

The situation in France is described as "fairly peculiar". Until recently virtually all loans were fixed rate, except for some state-subsidised loans. Since early 1988, a number of specialised institutions and banks have been offering customers reference rate loans combined with regulating mechanisms making it possible to limit the extent of any increase in the reference rate. The repayment amount cannot rise by more than the increase in the consumer price index, and if the reference rate rises by more than this the loan duration is extended.

Refinancing mechanisms

Variable rate loans are financed either by the conversion of savings deposits collected by lending institutions or through the capital markets. In most countries, savings deposits are the main source of variable rate loan financing. They offer greater security for loans of this kind than for fixed rate loans. However, there is a liquidity risk in that loans are granted for long durations whereas the refinancing is through savings deposits or shorter-term deposits.

Refinancing on the capital markets can take three distinct forms:

(a) Loans on the monetary market, which means that long-term loans are refinanced through short-term financing renewable for the entire duration of the loan at the market rate. The duration of such financing must be closely linked to the

Relative Importance of Variable Rate and Fixed Rate Loans by Country

		Belgium	*Denmark*	*FRG*	*Greece*	*Spain*	*France*	*Italy*	*Netherlands*	*Portugal*	*UK*
VARIABLE RATE LOANS	Reference rate loans	None	None	None	None	Virtually 100% of free sector	Small share but rising	Virtually 100% of free sector	Minor	100% of free sector and protected sector	Small share but rising
	Reviewable rate loans	None	None	Banks and savings banks	None	None	None	None		None	Virtually all loans
	Renegotiable rate loans	Majority of free sector	None	Mortgage banks, commercial banks and savings banks	None	None	None	Very limited share		None	Small share but rising
	Fixed rate loans	100% of subsidised sector	100%	Bausparkassen	100%	Very limited share of free sector 100% of subsidised sector	Virtually 100%	100% of subsidised sector	-	None	None

EC MORTGAGE RATES

periodicity of loan rate variation and to the revision index adopted.

(b) Issue of variable rate bonds with a duration equal to that of the loans and subject to variability conditions identical to those for loans.

(c) Issue of fixed-rate bonds which is well suited to renegotiable rate loans. With loans of this kind, rate variability is the result of the application of a succession of fixed rates over different loan periods.

Methods of variable rate loan refinancing are linked to the nature of lending institutions and to the nature of loans granted. Deposit taking institutions finance both variable rate loans and fixed rate loans essentially through the conversion of deposits. This is in some cases supplemented by recourse to the financial markets. Use of the financial markets is, of course, the rule for the non-deposit taking collecting institutions. Following is a brief country-by-country study.

In the *United Kingdom,* building societies, which have a predominant share of the mortgage market, grant reviewable rate loans which they finance by conversion of the deposits which they collect. They also have recourse to the financial markets. Specialised financial institutions offer renegotiable rate loans on expiry of an initial period of three to five years, during which the rate is fixed.

In *Spain,* reference rate loans, which are the major form of loan finance, are granted mainly by savings banks and banks which finance them primarily by conversion of deposits but also through mortgage bonds. Mortgage credit companies refinance their reference rate loans by issuing short-term mortgage certificates.

In *Portugal,* reference rate mortgage loans are financed through bank deposits and to a lesser, but growing, extent through variable rate bonds.

In *France,* subsidised loans distributed through the Crédit Foncier are refinanced through variable rate debenture loans. Reference rate loans granted by the mutual credit companies are financed by the conversion of deposits. Reference rate loans granted by specialised financial institutions are refinanced through financial markets.

In *Belgium,* loans with or without a five-year renegotiation clause are generally financed through five-year bonds or certificates, but banks and savings banks also convert deposits collected for loans of this kind.

In the *Netherlands,* commercial banks, savings banks and co-operative banks grant renegotiable loans which they finance by conversion of deposits collected. Mortgage banks refinance primarily through variable rate mortgage bonds.

In *Italy,* banks and savings banks offer reference rate loans which they finance by conversion, whereas mortgage credit companies refinance to 80% through variable rate mortgage bonds, usually at the same duration as that of loans.

In *Germany,* general banks and savings banks in particular offer reviewable rate loans on the basis of deposits collected. Mortgage banks, which grant renegotiable rate loans, refinance exclusively through mortgage bonds whose duration is aligned on that of their fixed rate commitment. There is also the special system of the Bausparkassen, which refinance the fixed rate loans they grant through the savings they collect.

Characteristics of variable rate loans

There are a number of features of variable rate loans which merit special consideration. The first of these is the option of early repayment. In most countries, reviewable rate or reference rate loans can be repaid early without any penalty; the only exception is for reference rate loans granted in Italy where early repayment, which is always possible, carries a penalty of at least 1%.

In the case of West Germany, although early repayment is possible without penalty for reviewable rate loans, the borrower must be given three months' notice. This liberalisation is due to the method of refinancing which means that the lender has no difficulty in replacing the amounts paid to him at the same rate or in reducing his refinancing.

This is not true for renegotiable rate loans. As a general rule, these loans can be repaid freely on expiry of the period throughout which a fixed rate is guaranteed. If repayment occurs during such periods, it is usually subject to a penalty and sometimes prior notice. This is the case in Belgium, where early repayment is subject to the payment of a penalty fixed by law at a maximum of six months' interest.

This is also true in the Netherlands, where early repayment during fixed rate periods is possible with one to three months' notice but subject to a penalty calculated according to the period still to run until the next revision and the rate difference. In Germany, even on expiry of the fixed rate period, early repayment without penalty is possible subject only to one month's notice.

In some countries there is the option to switch to a fixed rate loan. Conversion into a fixed rate is virtually impossible in the Netherlands and very difficult in the United Kingdom. In other countries, where both fixed rate and variable rate loans are available, borrowers always have the option of repaying their variable rate loans by means of a fixed rate replacement loan but then in addition to early repayment penalties, if any, they also have to pay costs for setting up the new loan. ■

Variability of Interest Rates on Mortgage Loans in the EC, published in English, French and German, may be obtained at the price of BEF600 per copy (postage included) from: European Community Mortgage Federation, Avenue de la Joyeuse Entrée, 14/2, B-1040 Brussels, Belgium (Fax: (32) 2 230 64 11).