Mortgage credit: the impact of 1993

By Jean-François Laugel and Eric Sovignet

MORTGAGE credit fulfils a substantial role in the banking sector. Mortgages outstanding come up second in the French banks' assets behind corporate loans. Their yearly growth has been 4% in real terms since 1983. In the white book of the European Community, an entire study was devoted to the subject. It is one of the few products whose evolution after 1993 may be governed by a specific directive, together with the general banking directive.

Mortgage credit is also a major component in the European strategy of several banking groups, which are active both in retail and in specialised banking activities. The example of the Compagnie Bancaire, in the largest sector of credit to individuals, speaks for itself. Its expansion policy in Europe consisted of 13 new ventures outside of France, including six new subsidiaries in two years.

All these reasons make one wonder what the impact of the single European market of 1993 will be.

On the basis of the evolution recommended by the European Commission, and the trends observed in five countries (France, FRG, Great Britain, Italy and Spain), we will:

- underscore national differences;
- identify barriers to entry;
- evaluate the impact of 1993 on these barriers.

From there we will estimate the evolution of mortgage credit in the single European market.

A market with national differences

Currently, mortgage credit represents a sector which is:

- relatively integrated, unlike the US, where there is an increasing specialisation of activities (eg, retail to individuals, secondary mortgage market, etc);
- not very innovative: in France, revisable rate loans, which have been on the market for two years or so, is one of the few new products;
- and one where only a few firms exploit niches which are usually orientated towards professional people (eg, foreign currency loans).

Nevertheless, the European countries differ on the following counts:

- competitive environment;
- products offered;
- and interest rates.

The competitive environment

The major participants vary from one country to the other. Specialised firms have large market shares due to factors which historically nurtured monopolies. Nevertheless, generalist banks have recently gained substantial shares in the market for new loans in a similar fashion for the five European countries considered.

In France, the Crédit Foncier and the Caisse des Dépôts manage 45% of the loans outstanding. The Crédit Foncier, which has so far enjoyed a monopoly in the distribution of privileged loans, is currently threatened by their disappearance. It must also defend itself against retail banks, which are becoming increasingly aggressive; these were behind 67% of new loans in 1987.

In the United Kingdom, the building societies attract 50% of public savings; these funds are earmarked exclusively for mortgages. The building societies were able to maintain a market share close to 75%.

In West Germany, two types of firms issue about 40% of mortgages. These are: the Bausparkassen, specialised firms which have a monopoly in the collection of savings destined to mortgage credit on one hand, and mortgage credit firms, which issue first-hand mortgages, on the other.

In Italy, mortgage credit firms have a monopoly over privileged loans, and still enjoy a 62% market share, while in Spain the savings and loan institutions can claim 54% of the market.

The products

There are also differences in the types of interest rates. Fixed rates are in the lead in France (except for certain privileged loans) and in Spain, where variable rates have only recently been introduced. In Italy, they still claim two-thirds of the market. In West Germany, rates that are fixed but subject to review every five or 10 years are frequent, while in the United Kingdom most rates are variable.

Distortions also appear in the maturities of loans: 10 to 15 years in Italy, up to 20 in France. In Spain, they are of 21 years, while in Great Britain and West Germany, they could reach 25 years and 30 years respectively.

It should be noted that France is the only country where housing savings ("Epargne Logement") are greatly successful.

The rates

The rates on mortgage loans vary enormously from one European country to the other. In West Germany, rates have ranged from 6.8% to 8.5% in the last few years, while Spain witnessed rates twice as high. The evolution of European mortgage rates between 1984 and 1988 (chart A) clearly illustrates these disparities.

How does one explain such differences? Will 1993 bring about a harmonisation in the European rates?

Barriers to entry

Differences like these can be explained by a relative absence of international competition amongst EEC countries, or from non-EEC countries, because of barriers protecting the various markets, notably:

- limitations on the flow of funds;
- restrictions on the entry of foreign actors in national markets;
- monopoly in the issuance of privileged loans;
- laws protecting consumers.

Mortgage rates are mainly a function of two parameters: cost of resources on the one hand, and overhead and margin on the other.

It is through these two parameters that barriers affect rates: by limiting the possibilities of access to resources, and by penalising a competitiveness that would allow a drop in overhead and margins.

Is it not surprising to note (chart B) a positive correlation between the ratio of overhead to assets and the ratio of net income to assets in the various countries? Those banks that have the highest overhead ratios are precisely the ones making the most money.

Limitations on the flow of funds

In the early days, the impact of 1993 on the issue of access to funds will be weak; the principle of the liberalisation in the flow of funds was adopted in June 1988 (the fiscal problem, however, remains pending), but the mortgage credit directive is expected to maintain the restriction of congruence, ie the necessity to back a mortgage with resources denominated in the same currency. This will constrain the actors in the way they manage their

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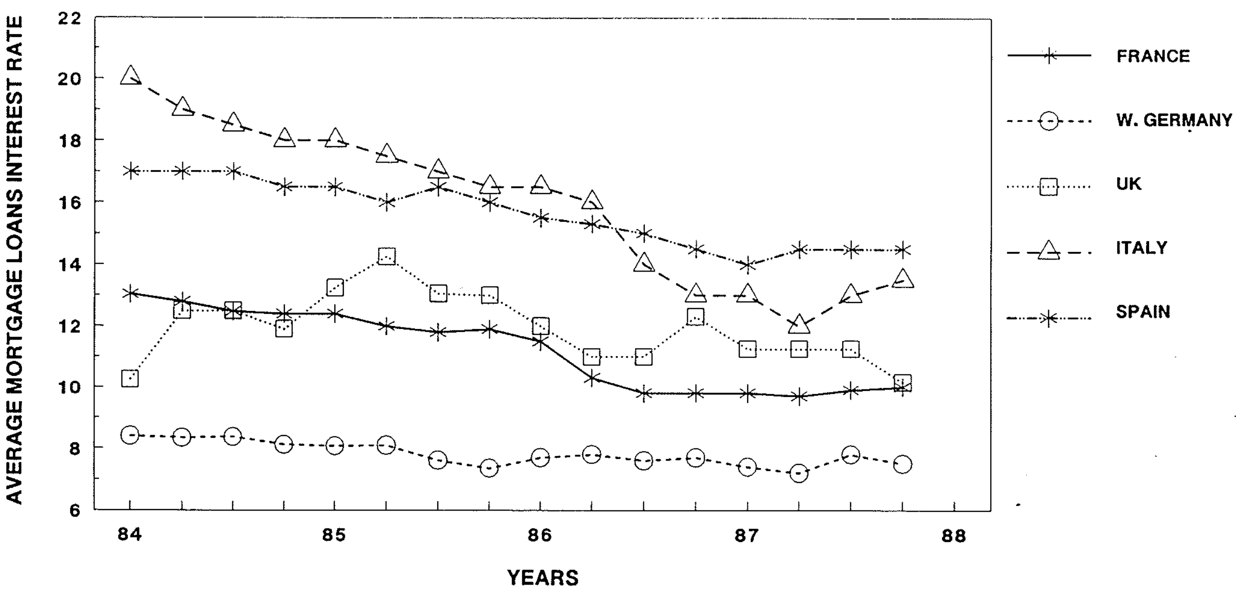
CHART A

MORTGAGE LOANS

INTEREST RATES IN EUROPE



Source : Fédération Hypothécaire

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refinancing and will penalise them in terms of cost of resources. It will, however, be possible to refinance in Ecu, the only exception to the congruence rule.

Restrictions to entry

Entry restrictions facing foreign financial firms (already present in the EEC) are expected to soften. This will speed up competition, but will not provoke a substantial disequilibrium.

Thus, entry into national markets could be facilitated within, however, the framework of mutual recognition. This framework remains to be defined in the second banking directive.

The current trend consists in allowing the sale of any product in a third country, provided that there is no direct selling. Thus, if the consumer is directly approached, the sale in the third country will be limited to those products that the bank's representative could sell directly. The full extent of this issue will become apparent once the texts have been finalised.

Monopolies

The monopoly in the distribution of privileged loans exists in those countries where this incentive is used to encourage property ownership. Such is the case in France, Spain and Italy. In Great Britain and West Germany, however, a system of fiscal deductibility was adopted. There is no reason why this monopoly should change after 1993. The discussions on the regulations that govern their distribution currently focus more on their cost to the relevant ministries than on the prospects of the single market. In France, the current thinking on the privileged loans has been barely changed by 1993.

Customer protection

To the extent that they are justified, laws protecting consumers will in all likelihood be maintained, although they will not be extended beyond the national markets. France, with the Scrivener law, offers a very favourable position to the consumer. Every product sold directly to the consumer in France will come under the regulation.

The impact of 1993

Consequently, the impact of 1993 will depend on the strength of the — potentially new — actors who will have to cope with national conditions that are not different from the ones prevailing now. The mergers that are taking place today in the banking and financial services sectors will have the same repercussions on mortgage credit; the national competitive arenas will include foreign banks and credit institutions, all offering similar products financed with local resources.

The only change that might take place is a drop in rates due to the entry in the national market of foreign actors with lower operating costs or margins. On this issue, the excess of average mortgage rates over money market rates, which could be a measure of the sum of operating costs and margins, reveals substantial differences across countries (chart C).

A differential impact across countries

It is, however, necessary to account for the particularities of each national market. These might be grouped under the three parameters that characterise the cost induced by the market:

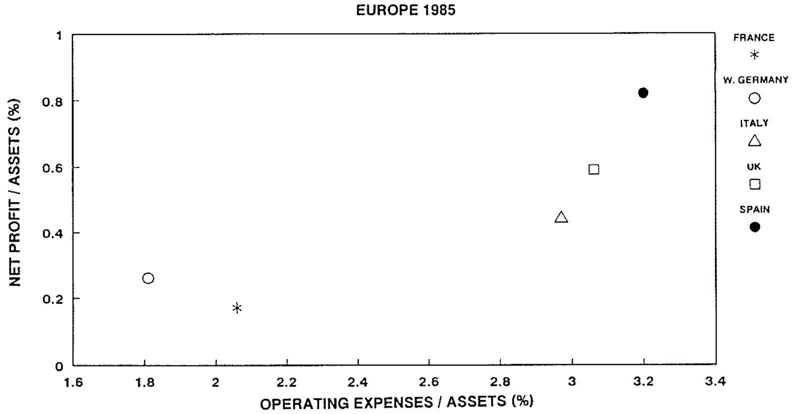
- the share of fixed rate loans;
- the percentage of property owners in the population;
- the laws protecting consumers.

The first two parameters relate the operating costs to the risks taken by the banks. Rate risk is determined by the proportion of fixed rate loans in an institution portfolio, whereas a higher proportion of property owners in the population means that the risk of lending at the margin is higher.

Therefore, in Great Britain, where variable rates are predominant, the risk incurred by mortgage credit institutions is smaller than that taken by their counterparts in France, where fixed rates are predominant. Similarly, in West Germany, where only 42% of the population owns property, marginal borrowers are less risky than are those in France, where the equivalent proportion is 51%. Finally, laws protecting consumers represent a further cost for French banks.

These disparities, assembled in table D, tend to have a different influence on costs in the different countries. It thus appears that, in France and Spain, operating costs and

CHART B
PROFITS AND OPERATING EXPENSES
EUROPE 1985



SOURCE:OCDE

market-induced costs are both high. The magnitude of the latter is explained, in France, mainly by the share of fixed rates and the existence of laws protecting consumers, and in Spain by the prevalence of fixed rates and the high percentage of the population owning property.

More detailed analysis would be necessary in order to discover the exact cost of each market characteristic. Nevertheless, this approach leads to the conclusion that the most expensive countries are those where financial institutions are subject to nation-specific constraints.

Conclusion

The European mortgage credit should not change drastically with the coming of 1993. A drop in rates resulting from the entry of foreign actors with lower operating costs is conceivable, although this will be modified by the existence of nation-specific costs.

On the other hand, some firms, which are very competitive in their home market, will be able to export their know-how. They might even achieve scale economies or experience gains that will allow them to compete effectively in new national markets with new players.

In this respect, firms that already master the mechanisms of securitisation (under the form of mortgage-backed securities) could quickly become efficient by positioning themselves in markets opening to this technique.

It is here that the major impact of 1993 on the mortgage credit sector is to be found. ■

CHART C
MORTGAGE CREDIT

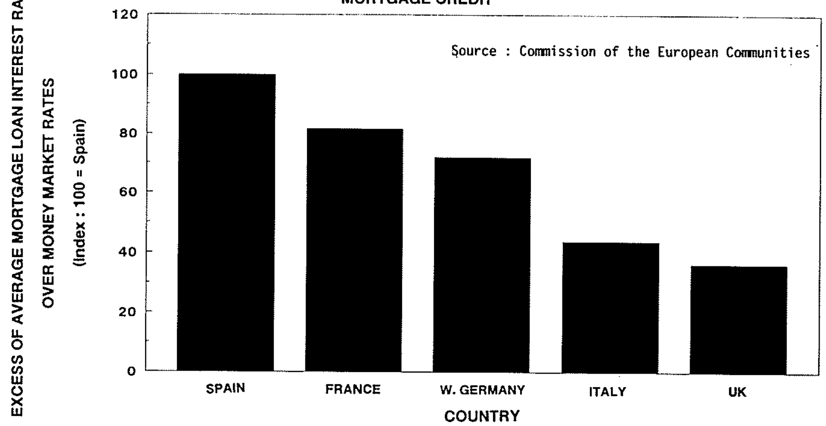


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TABLE D

MORTGAGE CREDIT

	EXCESS OF AVERAGE MORTGAGE LOAN INTEREST RATES OVER MONEY MARKET RATES	COST RESULTING BY THE MARKET CONDITIONS			TOTAL COSTS RESULTING FROM MARKET CONDITIONS
		% FIXED INTEREST RATE	% HOME OWNER	PROTECTION OF THE BORROWER	
FRANCE	***	***	*	**	***
WEST GERMANY	**	*	-	*	*
UK	*	-	**	*	*
ITALY	*	**	**	-	**
SPAIN	***	***	***	-	***