European integration : prospects for the mortgage lending industry

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A. DIVERSITY OF PROPERTY AND MORTGAGE MARKETS

European property and mortgage markets are structurally very different for many reasons. However there are powerful forces which may soon bring about significant changes. In particular, the introduction of a single currency has led to increasing integration of the fifteen hitherto autonomous economies. On January 1st 1999, the first 11 Member States embarked on the third and final stage of this important project and merged their national currencies into a single currency which will rival the dollar in terms of economic importance.

This process will have major implications for European property markets and the financial systems which serve them. Property and mortgage markets remain intrinsically domestic, although the driving force for change will come as a result of the creation of a deep and liquid single capital market. This may fundamentally change the current situation.

This paper will therefore seek to:

- highlight the major differences between European property and mortgage markets
- explain the principle funding mechanisms which serve them;
- and examine the potential impact that the forces of change - in particular the introduction of a single currency - will have on future developments in the mortgage market.

1. Housing Markets in the European Union

Housing markets differ substantially across the European Member States. Many factors have conspired to bring about such differences, but among the main reasons are the following;

- Different economic circumstances;
- Different legal systems and property laws;
- Different taxation systems and social policies;
- Different cultures and traditions;

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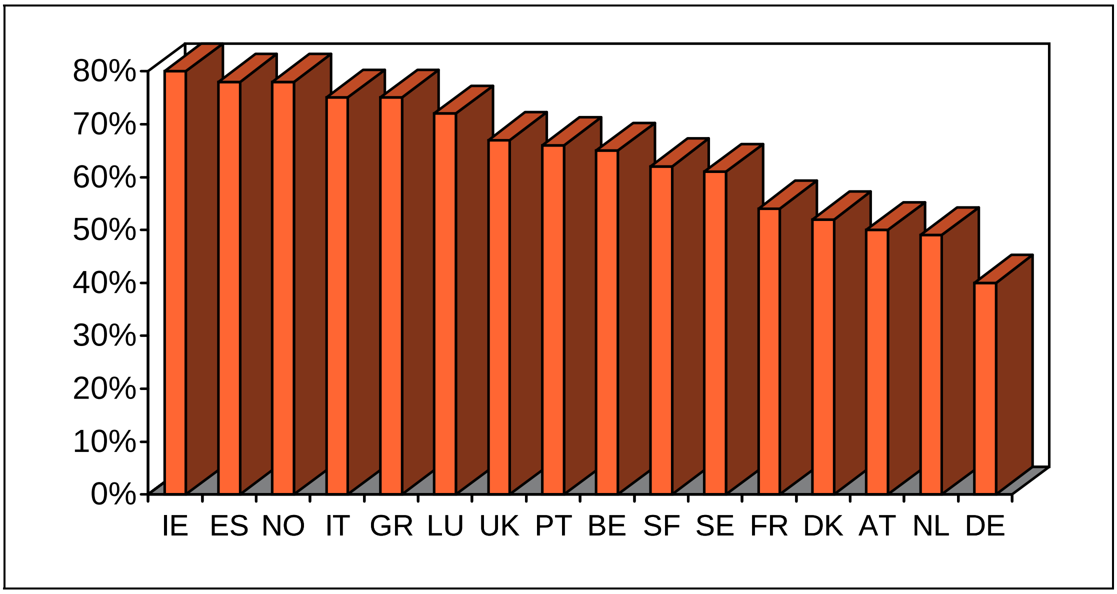
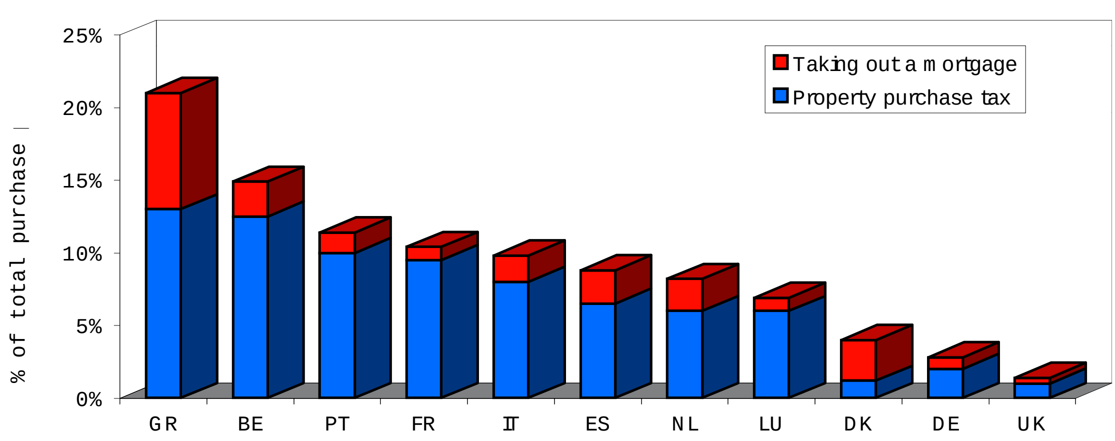
[1] The European Mortgage Federation is based in Brussels. It represents mortgage lenders from all 15 EU Member States; together they represent more than 75 % of outstanding mortgage loans at EU level. Its Dutch members are the Nederlandse Vereniging van Banken, the Algemeen Burgerlijk Pensioenfonds and the Bouwfonds Hypotheken BV.

Graph 1: Different levels of owner occupation



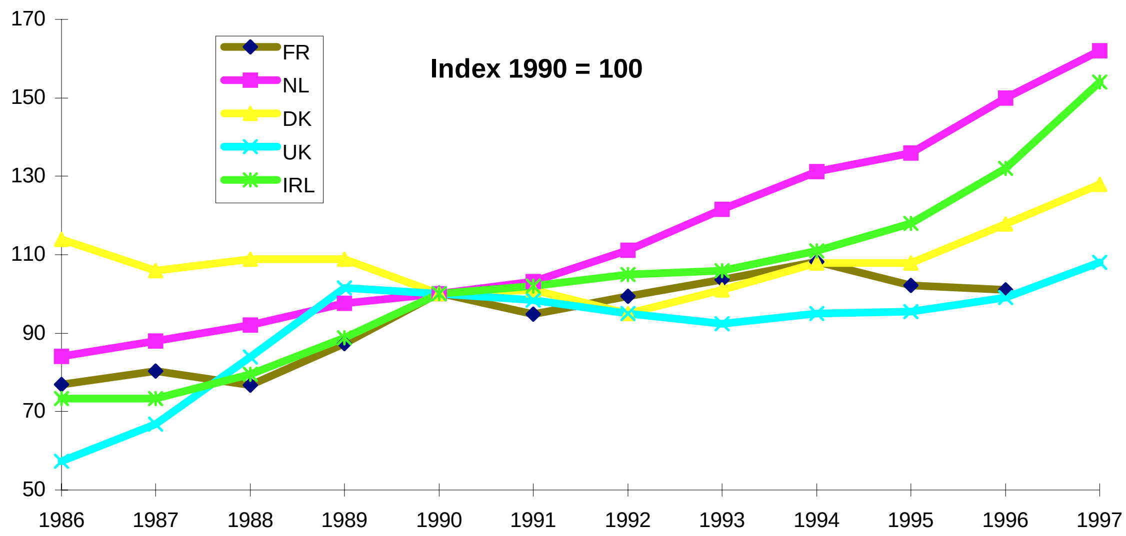
Property law and housing policy are regulated at national level. This in part might explain the very different property market structures which exist across the European Union. Perhaps one of the most striking comparisons is the very different levels of owner occupation which are to be found across the various Member States. The number of households in owner occupation ranges from 80% in Ireland to just 40% in Germany. Indeed, in Germany where housing is very costly, government policies have tended to favour the development of an abundant supply of private rental dwellings. In Ireland, the high level is not so much the result of a deliberate social policy to favour owner occupation, rather it is the result of historical factors, and in particular a counter-reaction to the power of private landlords, which has resulted in a strong tradition of own home ownership since independence. Very different circumstances have therefore led to such diversity in tenureship structures in the European economies.

Graph 2: Different costs linked to the purchase of a dwelling



Taxation systems also vary considerably across Member States, and have a substantial influence on the way housing markets are structured. Graph 2 illustrates the very different level of costs associated with the initial purchase of a dwelling across the different Member States. The most important component is tax, which amounts to as much as 13% in Greece compared to just 1-2% in the United Kingdom. Such differences impact strongly on access to home ownership and the relative mobility of housing markets.

Graph 3: Different house price trends

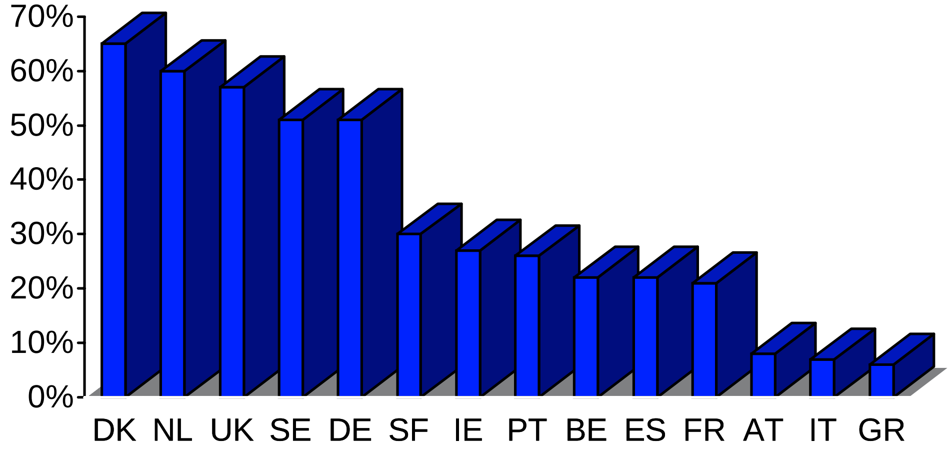


House prices across the European Union are at very different levels. It is difficult to compare absolute levels across the Member States, as the type and quality of housing are so different. A comparison of the different trends, however, reveals the extent to which markets remain structurally different. The main contrast is between economies where house prices remain relatively stable, and those which display greater volatility. The UK is an example of a relatively volatile market, where prices peaked in the late 1980's, and were followed by a prolonged period of stagnation. In contrast, in the Netherlands, there has been a sustained house price boom, in connection with a shortage of available housing and generous tax treatment. The performance of house prices over time influences the appetite for home ownership.

2. Mortgage Markets in the European Union

The mortgage markets which serve these residential property markets are also structurally very differently across the Member States. Mortgage credit plays a very important role in the overall EU economy, representing approximately 30% of GDP in the European Union and amounting to over ECU 3 trillion.

Graph 4: Residential mortgage loan as % of GDP in 1996



Levels of mortgage indebtedness range from 65% of GDP in Denmark to just 6% in Greece. This is not correlated to the different levels of owner occupation. The extent to which households take on mortgage debt is linked to the stability of the economy, the efficiency of the mortgage lending system, the cost of housing, fiscal incentives, etc.. In Denmark, high taxation levels in conjunction with generous relief linked to mortgage credit have stimulated high levels of mortgage debt. In contrast, until recently mortgage rates in Greece were at 23% while inflation was running at 15%. Similarly rates were historically high in Italy, while at the same time the legal process for mortgage lenders to repossess mortgaged property can typically last 6 years. In such circumstances, it is perhaps unsurprising that there has been far less recourse to mortgage credit in these countries.

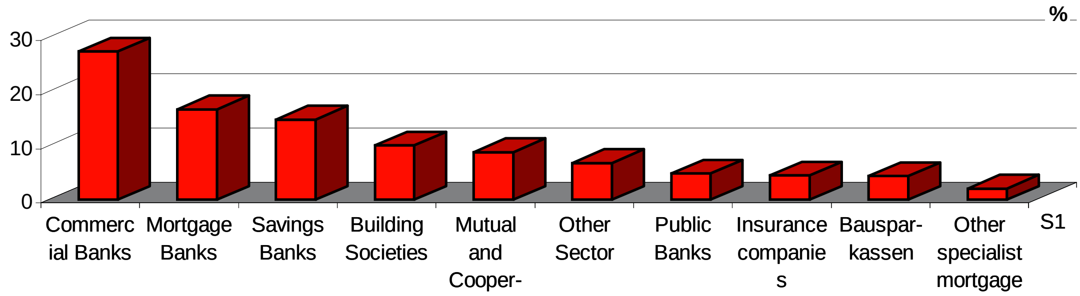
In these diverse circumstances, the different markets have spawned very different mortgage products. The typical duration of a mortgage loan can vary between 10 years in some Southern countries to as much as 30 years in Denmark or Germany. Different approaches to consumer protection regulation can result in only a handful of products offered in some countries, compared to over 4,000 products currently on offer in the UK. In certain countries, there is a predominance of fixed rate mortgage products, while in others, variable rates are more common. In short, the markets have evolved around very different sets of circumstances.

Table 1: Typical mortgage products

	UK	DE	ES	FR
Duration of a loan	25 years	25-30 years	10-15 years	15 years
Type of interest rate	reviewable	renegociable reviewable	+ /- 90% reference	50% reference 50% fixed

In certain countries, the introduction of tight consumer protection rules has resulted in mortgage credit becoming increasingly separated from its sources of funding. For example, complex rules on the variation of mortgage interest in Belgium, which require the change in interest rate to be linked to government bond indices rather than to the true cost of funds for mortgage lending, introduce an interest rate risk. Rules which limit prepayment penalties charged to consumers by borrowers will also complicate the funding process, and may induce a dangerous situation of mismatching.

Graph 5: Market players



The housing finance systems which operate on European markets have also evolved independently, resulting in a wide variety of institutions offering mortgage loans. In some countries, mortgage loans are offered by specialist institutions such as mortgage banks, building societies, *Bausparkassen* (i.e. "dedicated savings" institutions), etc. Elsewhere non-specialised lenders such as commercial banks, savings banks and insurance companies play an important role.

The type of institution offering mortgage credit has important consequences for the way in which mortgage credit is funded. In recent years, the trend has been towards de-specialisation. Nevertheless, the combined weight of the various types of specialist institution is still significant. The funding of mortgage credit is split between retail markets and the wholesale capital markets. The bulk of mortgage funding is still through various types of savings deposits, although there is increasingly recourse to the capital markets, in particular through the issue of mortgage bonds. In terms of outstandings, Mortgage-backed securities continue to play a relatively minor role, although institutions in many Member States are increasingly looking to this new instrument to fund their mortgage assets.

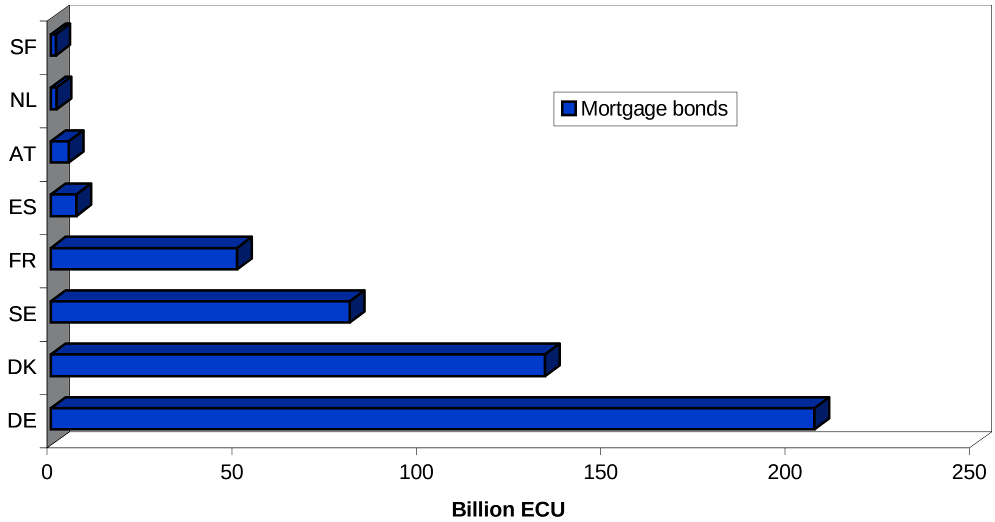
In Germany and Austria, the *Bausparkassen* attract savings at below market rates, and after a contractually agreed period and with the help of a government subsidy, the borrower is entitled to benefit from below market rate mortgage loans. This is a dedicated savings system which performs in isolation from wider movements on the capital market.

In France, a system has evolved whereby a government subsidy on certain forms of savings deposits ensures a steady flow of capital for housing purposes. More recently, the French government has been trying to move away from such systems which can result in a situation of mismatching, whereby interest rates on dedicated savings accounts were higher than interest rates on mortgage loans.

The mortgage bond is, by contrast, typically a long term fixed interest rate product. Mortgage bonds are generally issued by the specialist mortgage banks, and are regulated by law. They are financial securities which have as a collateral the corresponding bundle of mortgage loans, and represent guaranteed claims against what are considered to be particularly secure types of credit institution. Furthermore there are limits to the loan-to-value ratios of the mortgages which are included in the pools, and in some cases the valuation techniques are also strictly defined. In terms of volume, this form of funding instrument represents the largest category of securities in European capital markets after government issues. Mortgage bonds provide almost 20% of the funding of all mortgage credit in Europe and at the end of 1997 amounted to some Ecu 500 bln[2].

[2] This excludes the figure for Italian mortgage bonds

Graph 6: The importance of mortgage bonds in the Member States



At present, three countries in the EU share more than 4/5 of the overall mortgage bond market: Germany is in the lead with 46% of the issues, followed by Denmark (24%) and Sweden (12%). The remainder of the market is shared between Spain, France, Finland, Austria, and the Netherlands.

B. HOW DEVELOPMENTS AT EU LEVEL WILL SHAPE EUROPEAN MORTAGE MARKETS

The current situation of fragmented mortgage and property markets is increasingly subject to external factors of change which should, in the long run, lead to a greater degree of homogeneity. Among the major factors for change are the initiatives adopted by the European Union, including the creation of the single market and the introduction of the single currency, which will determine the future of the mortgage lending industry.

The internal market

The 1992 internal market programme was aimed at liberalising financial services markets. The EU adopted a number of directives, including the 2nd banking directive which was based on the principle of home country control. This means that mortgage lenders are now free to provide services across EU borders subject to supervision from the home supervisors. In 1989, when the directive was adopted, many experts believed that this directive would help liberalise mortgage markets. However, 10 years after its adoption, few mortgage institutions have used the possibilities provided by the 2nd Banking Directive. According to a survey carried out by the Federation, one of the fundamental problems in cross-border mortgage lending is the uncertainty presented by the current legal framework and the difficulty in exporting national products.

In practice, the freedom to provide mortgage services is also limited by the possibility for host Member States to impose their national consumer protection measures on the basis of the concept of "general good". As a result, credit institutions wishing to offer mortgage loans on a cross-border basis are required to comply with a maze of complex host country rules.

The European Court of Justice monitors the interpretation of the general good rules. Credit institutions therefore have to prove that general good measures are, for instance, disproportionate considering the aim they pursue, i.e. protecting the consumer. Experience shows that most institutions recoil from long and costly procedures and consequently shelve their plans to enter particular markets.

This obstacle is more easily tackled by large banks with the financial capacity to buy local mortgage operations in other Member States. Small, specialised mortgage lenders however have to rely on cross-border operations.

These legal problems are further complicated by the fact that there is a lack of clarity as to which law (that of the consumer or that of the credit institution) should apply to the mortgage contract.

If the Commission wishes to favour cross-border business, it needs to clarify the legal framework for cross-border mortgage lending. The present legal framework (2nd Banking Directive, Brussels and Rome Conventions) for cross-border mortgage operations is inadequate and gives rise to legal uncertainties. This is in the interests of neither the mortgage borrower nor the mortgage lender.

Consumer Protection legislation : an important factor for change.

With the adoption of the Maastricht treaty, consumer policy has moved higher up the European agenda. Indeed, Article 129A states that the « Community shall contribute to the attainment of a high level of consumer protection ». In 1995, the Commission published a report which recommended that minimum harmonisation in the field of mortgage credit would be desirable. In 1996, the Commission commissioned a study which examined whether the 1987 consumer credit directive could be applied to mortgage credit.

The study concludes that in most Member States, consumer protection standards for mortgage lending « meet or exceed the minimal requirements of the Consumer Credit Directive». However, because of the diversity of housing finance systems, Member States have taken very different routes to achieve this aim. The authors were doubtful whether the introduction of higher consumer protection standards would favour cross-border mortgage lending. Indeed, the Commission's two objectives (high consumer protection standards and completion of the internal market) are to some extent contradictory.

Indeed, since the 1987 Consumer Credit Directive introduces minimum standards, almost all Member States have gone beyond these minimum requirements and introduced new rules which vary greatly from one country to another:

- countries which have introduced *strict consumer protection regulations:* FR, ES, BE, IE, SE
- countries with regulations regarding *specialised lenders*: DE, DK, SE, AT, UK
- countries with *strict product regulations (i.e. Bausparkassen)*: DE, AT
- countries which have adopted *mortgage codes* : UK, NL, DK

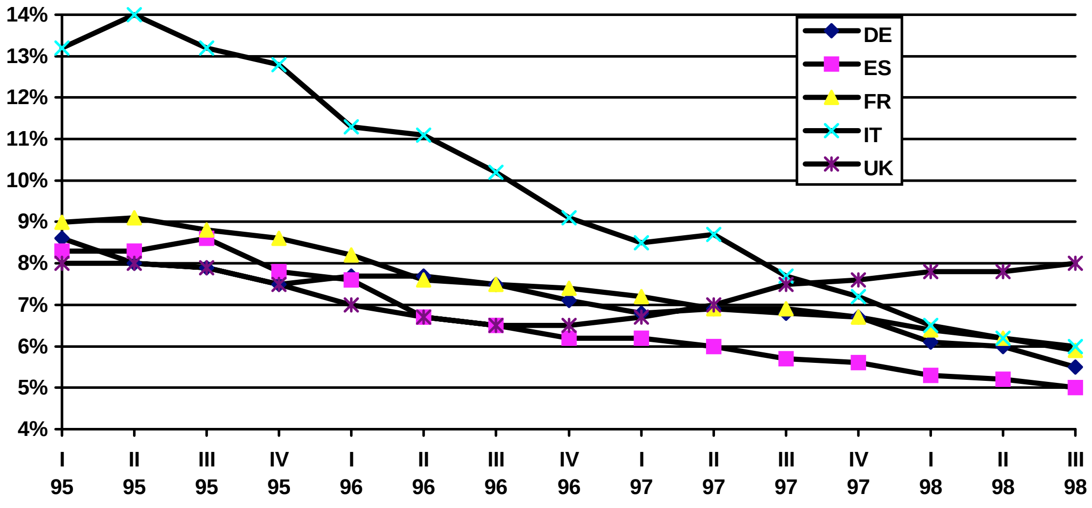
Similarly, a mortgage credit directive could also only introduce minimum standards. This would in fact result in a lowering of consumer protection standards in those countries with very strict rules. Consumers in these countries may find this difficult to accept. Furthermore, if there is minimum harmonisation, host countries will not be able to invoke the «general good» clause to bar entry to mortgage providers from other Members States. Moreover, since host country banks would continue to be subject to stricter regulations, they fear potential distortions of competition, so-called « reversed discriminations ». Consequently, mortgage lenders from these Member States argue that the national law of the consumer should always apply.

Consequently, many experts agree that it would be extremely difficult to find an agreement on how to harmonise mortgage credit and that minimum harmonisation would not help create a single mortgage market.

The euro increases the need for transparency

The euro will incontestably have an important impact on European mortgage markets. A stable economic environment will promote low, stable mortgage rates and longer-term loans, thereby encouraging the acquisition of owner occupied housing. Mortgage interest rates in most EU Member States have decreased significantly with the adoption of the convergence programme set out in the Maastricht treaty.

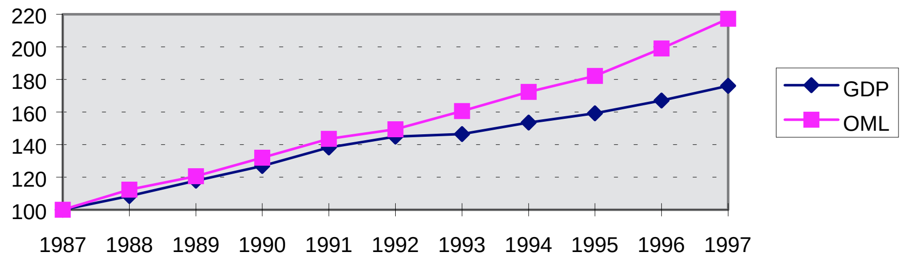
Graph 7: Convergence of mortgage interest rates



The decrease of mortgage interest rates has had a positive impact in most mortgage markets in Europe and outstanding mortgage loans have increased significantly in practically all EU Member States.

Graph 8: Mortgage lending outstripes growth of the Economy

Graph 8 shows how total outstanding mortgage debt in the European Union has, in nominal terms, more than doubled during the past 11 years, while GDP has developed at a slower rate.



Mortgage borrowers will benefit from keener competition, reduction in costs, diversification in mortgage products and savings products intended for households and greater transparency in prices. Greater price transparency will allow borrowers to compare the prices of houses and loans more easily and encourage them to conclude contracts with credit institutions from other Member States.

In cross-border situations, it is essential that potential borrowers are informed properly about the proposed mortgage loans and that they are able to compare them. This has triggered discussions at EU level on the need to improve the transparency and comparability of information on mortgage products. Since mortgage credit is among the most important financial transactions from the consumers' point of view, the European Commission will continue to press the mortgage lending industry to improve information standards.

Furthermore, in the case of cross-border shopping, borrowers need to be made aware that there are major differences which exist between the different mortgage markets and products, including taxation systems, transaction costs, forced sale procedures and in some cases the role of the notary.

Taxation - a stumbling block ?

Borrowers wishing to shop across borders for better value mortgage products in other Member States risk being disappointed. The European Mortgage Federation has conducted a survey aimed at identifying certain tax and subsidy related obstacles, and has highlighted a number of the possible difficulties a borrower could encounter.

For instance, a borrower in Austria who wishes to deduct his foreign insurance premiums from his annual tax bill may face problems.

Nor is it possible in a number of countries to obtain direct mortgage subsidies in the form of interest rate reductions, unless the contract has been concluded with a domestic institution. This is notably the case in Greece, Italy and Portugal, although a number of other countries require the lending institution to have already entered into a special agreement.

In Greece, the borrower is subject to an additional stamp duty of 3.6% of the contract value if the loan is with a foreign credit institution, while in Italy Austria and Portugal, the mere fact of signing a loan contract will be considered as a taxable event.

Such examples represent just some of the obstacles which have been highlighted by the EMF's survey. Indeed, borrowers risk a number of possible pitfalls when venturing outside their national territory in order to take out a mortgage loan with a foreign credit institution. Given the relative complexity of mortgage products, it is probable that many other difficulties will arise in the future and the disappearance of the exchange rate risk is therefore unlikely to substantially change consumers' borrowing habits.

CONCLUSION

Until now, primary mortgage markets have been surprisingly resistant to change, as both mortgage and property markets are tightly enshrined in national law. Differences in tax and subsidy rules, consumer protection rules and the fact that mortgage lending has always been considered as a local business, will mean that the achievement of a single European market in the field of mortgage credit can only take place in the longer term.

However these structural differences are increasingly subject to the forces of change which strive to impose a certain level of homogeneity.

The extent to which mortgage and property markets will change in light of such pressures is currently not clear, although it is likely that change on the capital markets will be the precursor for change on the primary markets. Common economic circumstances, in particular if the euro proves to be a stable low inflation environment, should be a further factor of change.

Mortgage bonds and mortgage backed securities, both specialist mortgage instruments, should prove particularly attractive in this new environment, while mortgage funding through savings is likely to become increasingly subject to competition. The development of a single capital market will lead to new opportunities for the wholesale funding of mortgages, resulting in new products on the primary markets.

The introduction of the euro will also highlight the need for a harmonised approach in the field of taxation, which has also been accorded a higher priority on the Commission's agenda. For instance, the Commission is presently examining the possibility to harmonise withholding tax on savings income, tackle the problem of double taxation of cross-border interest and royalty payments and is also considering to introduce VAT on financial services and property.

Consumer protection will likewise continue to shape the EU legislative agenda. Mortgage lenders will face continuing pressure from consumers and the Commission to improve the transparency and comparability of mortgage offers.

If the single European mortgage market has proved an elusive goal in the past, it must be considered to be a realistic possibility in a single currency area. However further progress will needed in all the above areas in order to achieve this.

Sources:
Graphs 1, 3, 4, 5, 8
European Mortgage Federation *"Hypostat 1987 - 1997"*

Graph 2:
European Mortgage Federation "*Costs involved with the Purchase of a Second-Hand Dwelling and a Second-Hand Commercial Building in the EC"*

Graph 6:
European Mortgage Federation "*The Euro and Capital Markets", July 1997*

Graph 7:
European Mortgage Federation "*Quarterly Figures"*

Table 2:
European Mortgage Federation "*Owner-Occupied Housing in the EU: Tax Aid, Subsidies and Costs"*