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COMMISSION OF THE EUROPEAN COMMUNITIES

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GREEN PAPER

Mortgage Credit in the EU

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(Text with EEA relevance)

TABLE OF CONTENTS

INTRODUCTION

(1) This Green Paper is the central part of the process to assess the merits of Commission intervention in the EU residential mortgage credit markets. Another key aspect of this assessment process is a Commission funded study on the costs and benefits of further integration of these markets.[1] There will be a Hearing in December 2005 to mark the conclusion of the consultation process.

(2) Consideration of intervention in the EU mortgage credit markets is a key aspect of the Commission's commitment to meeting the 'Lisbon' objectives aimed at enhancing EU competitiveness.[2] It forms a very important element of the Commission's policy for the integration of financial services in general and retail financial services in particular.[3] A more efficient and competitive mortgage credit market that could result through greater integration could contribute to the growth of the EU economy. It has the potential to facilitate labour mobility and to enable EU consumers to maximise their ability to tap into their housing assets, where appropriate, to facilitate future long-term security in the face of an increasing ageing population.

(3) Without prejudging the follow-up of this Green Paper, the Commission is fully aware of the importance and impact of mortgage lending on the EU economy. It is, however, too early in the consultation process for any decisions on whether the Commission should act, let alone for assessments of which instrument(s) might then be most appropriate. What is clear is that any action that the Commission might take to integrate these markets would be aimed at making them more efficient and competitive for the benefit of all. This could be achieved by ensuring that mortgage credit can be demanded and offered with limited hindrance throughout the EU and that market completeness, product diversity, and price convergence are enhanced. The Commission appreciates the merits of a more liquid funding market, based on modern and flexible funding techniques and products. It is aware of the emergence of new products, such as *equity release**, which merit careful assessment with regard to both their potential risks for consumers and their perceived ability to offer new sources of finance to EU citizens, in particular with a view to addressing the pension financing problems which current and future generations will inevitably have to face. Finally, the Commission is aware of the impact of this market on the well-being of EU citizens. There is a huge social and human dimension attached to housing and credit, including aspects such as over-indebtedness. Any policy in this area must take that dimension into proper consideration.[4]

(4) The Commission will consider carefully all input received through this consultation process. Action will be proposed by the Commission after the consultation process only if it is demonstrated that there is a clear business case for Commission intervention in the EU residential mortgage credit markets, i.e., if the potential benefits

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* All words and terms in *italics* are defined in the Glossary at Annex III.

1 This study will be published on the DG Internal Market and Services website in August 2005 http://europa.eu.int/comm/internal_market/finservices-retail/index_en.htm.

2 COM (2005) 141. Growth and jobs: A new start for the Lisbon strategy.

3 COM (2005) 177. Green Paper on Financial Services Policy (2005-2010).

4 For details on the Commission's policy on poverty and social exclusion see http://europa.eu.int/comm/employment_social/social_inclusion/index_en.htm.

of intervention can outweigh the anticipated costs of such intervention. Any future initiatives, not necessarily of a regulatory nature, would be announced in a White Paper setting out the results of the consultation, to be issued in 2006. Such initiatives would be subject to a thorough impact assessment.

(5) Responses to this Green Paper must be received by 30 November 2005 at the following email address: mortgage-consultation@cec.eu.int. Responses will be placed on the Commission's website, unless there is an explicit request to the contrary.

I – ASSESSING THE CASE FOR COMMISSION ACTION

(6) The EU mortgage credit markets constitute a crucial aspect of the overall economy of all EU Member States. At the end of 2004, the value of outstanding residential mortgage loans represented about 40% of the EU GDP.

(7) Mortgage credit markets are amongst the most complex markets in which consumers engage. The 'value chain' of a mortgage transaction can involve different and specialised market players at each stage. Mortgage brokers, packagers of products, specialist/generalist lenders, issuers and purchasers of *securities* and *bonds* (including global investors), insurers, and even government agencies can be involved in the purchase of a single home by a single EU consumer. The importance of the EU mortgage credit markets cannot be overestimated in the recent, current and future economic climate.

(8) For most EU citizens, the purchase of their home represents the largest purchase in their lifetime. Most home purchases require a loan for part of the price. Such loans are usually, but not always, secured by a mortgage. This debt is likely to be the most significant on-going financial commitment for most EU households. That said, the *equity* in the home can represent a substantial asset which may have the potential to be used to finance consumption or retirement. Thus the level of mortgage debt and the contractual characteristics of that debt can play a direct role in the transmission of monetary policy and on economic activity as a whole. For example, contractual restrictions on or penalties for early repayment of the debt may delay the transmission of changes in interest rates and hinder refinancing in such circumstances. This relationship between the macro-economy and mortgage debt is highly significant, especially in flexible mortgage markets, as the slightest change in interest rates can have a significant effect on household budgets and spending capacity. This can have a noteworthy impact on debtors, with a potential knock-on effect, positive or negative, on their spending and asset levels.

(9) Most EU mortgage markets have been expanding rapidly in recent years. In many Member States outstanding mortgage debt is currently at historically high levels relative to GDP or household disposable income. The growth of mortgage lending has been fostered both by macro-economic factors (such as the fall in interest rates and the strong growth of house prices in some countries) and structural developments (such as the increasing liberalisation and integration of EU financial markets). However, what is apparent is that the EU mortgage credit markets, despite sharing some common trends, remain very diverse. Relative sizes vary, as does growth. Product variety, borrower profiles, distribution structures, loan durations, home-ownership rates and funding mechanisms differ considerably.

(10) These differences in mortgage and housing markets reflect Members States' attitude to regulation, economic history and cultural factors. Differences in outcomes are related to factors such as direct government intervention in housing markets (e.g. by means of fiscal incentives to home-ownership), prudential regulation (e.g. regulatory ceilings to *Loan to Value Ratios*), the level of competition in mortgage markets, housing rental market conditions (including the availability of social housing) and the perceived risk associated with mortgage lending (in particular, the costs and the time required to realise the *collateral*'s value in the event of default).

(11) Many external sources[5] and the Commission's on-going consultation support the view that these markets are not very integrated, notably in relation to the range of available products and cross-border mortgage activity, while price differences (spreads) are already relatively low. A recent study[6] came to the conclusion that these markets were individual markets with their own characteristics and economic drivers. Also noted was little connection between national market participants in the *primary* and the *secondary markets*, other than global investors in *mortgage bonds* and *mortgage backed securities* (MBS). The level of direct cross-border sales is low, less than 1% of overall residential mortgage credit activity[7] and largely confined to the purchase of holiday homes or border region purchases, both niche market sectors.

(12) So what are the potential benefits of such integration? The Commission's out-sourced study will present and quantify these potential benefits, which have been highlighted elsewhere already.[8] An overall lower cost of the mortgage or home loan could be a prime potential benefit. Improved product completeness in ancillary products (e.g. example mortgage insurance products), as well as in core mortgage credit products (e.g. *equity release* products and flexible mortgages) is a potential benefit. The Commission follows with interest the emergence of such innovative products (they are currently present in only a handful of Member States), and is fully aware of the need to accompany such emergence with a high level of consumer protection. Another key benefit appears to be the potential to serve more borrowers, including those currently marginalised in many EU mortgage credit markets such as sub-prime borrowers (i.e. those with poor or incomplete credit ratings). As with integration in other financial services sectors, improved economies of scale are certainly possible. Diversification across borders and through increased use of the *capital markets* and insurance markets could also serve lower credit risk. Finally, there is potential for improved capital efficiency, that is, the capacity for capital to move to those markets where it is most needed and rewarded.

(13) As part of its assessment of the case for action in the EU mortgage credit markets, the Commission has analysed the 48 recommendations of the Forum Group on Mortgage Credit, which it created in March 2003 in order to assess the barriers to further integration of the EU mortgage credit markets and propose ways to address them.[9] These recommendations cover most of the issues relevant to the integration of EU mortgage markets. The Commission is determined to make the best possible use of these recommendations in any action it may propose in the future. It is however clear that not all of these recommendations would require the same course of action and that some require more ground work before any decision can be made.

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5 Report of the Forum Group on Mortgage Credit, "The Integration of the EU Mortgage Credit Markets, DG Internal Market, December 2004; European Financial Integration: Progress and Prospects, European Commission 2004; Study on the Financial Integration of European Mortgage Markets, Mercer Oliver Wyman for the European Mortgage Federation, 2003; International Trends in Housing Tenure and Mortgage Finance, Council of Mortgage Lenders 2004; Risk and Funding in European Residential Mortgages, Mercer Oliver Wyman for the Mortgage Insurance Trade Association (MITA) April 2005.

6 Study on the Financial Integration of European Mortgage Markets, Mercer Oliver Wyman for the European Mortgage Federation, 2003.

7 Eurobarometer Report, 2004.

8 See footnote 5.

9 http://europa.eu.int/comm/internal_market/finservices-retail/docs/home-loans/2004-report-integration_en.pdf

(14) The Commission shares the Forum Group's view that integration of EU mortgage credit markets necessitates addressing four main distinct but interrelated areas: consumer protection, legal issues, *collateral* and funding. This Green Paper examines these four areas. The Commission welcomes views on all issues covered in this Green Paper, on any further issues considered key to the increased integration and efficiency of the EU mortgage credit markets, and on their prioritisation.

II – CONSUMER PROTECTION

Information

(15) Information provision is a crucial issue in mortgage transactions, given their complexity, relative high cost and long duration. A degree of information asymmetry between the average borrower and provider is inevitable. What is crucial in this context is that the borrower is provided with the appropriate level of information necessary to take an informed decision, in a manner and at a time when such information provision is most effective.

(16) The Code of Conduct[10] has created, through the European Standardised Information Sheet (ESIS), a precedent for standardising pre-contractual information at EU level. The Commission has initiated a review of the Code, including an external study[11] which indicated that implementation, at that time, was not satisfactory. The Commission will await the result of this consultation to make final decisions about the Code. But the following questions need to be addressed:

- Should the Code of Conduct be replaced by binding legislation or remain voluntary?
- What information should be given to consumers? A careful balance must be found between information deficiency and information overload.
- The Commission considers it fundamental that pre-contractual information is provided at a stage that enables the consumer to shop around and compare offers. Can such a common EU stage be identified, given the variations in Member States' traditions and legislations?
- Should an information provision regime apply only to lenders or to others such as brokers too? How can compliance with any such regime (binding/voluntary) be ensured?

Advice Provision and Credit Intermediation

(17) Mortgages are complex high value products. Advice on them tends to be sought more often than on most other financial services products. Different kinds of consumers may have different kinds of needs from their providers and different kinds of relationships with them.

(18) The Commission is aware of the potential consequences of compulsory advice provision on product pricing (by direct charge or through indirect affect on the product price) and on lenders' potential exposure to legal risks. But it is aware also of the

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10 C (2001) 477. Voluntary Code of Conduct on Pre-Contractual Information for Home Loans.

11 Monitoring the Uptake and Effectiveness of the Voluntary Code of Conduct on Pre-Contractual Information for Home Loans, Institute for Financial Services, 2003. http://europa.eu.int/comm/internal_market/finservices-retail/docs/home-loans/home-loans-final-report_en.pdf.

important role adequate advice provision can play on consumer confidence and in the prevention of problems such as over-indebtedness.

- Should the provision of advice to the borrower be made compulsory or be a matter of choice?
- Should conditions be applied to any advice actually provided, whether under a duty or by choice (e.g. standards for the advice, sanctions for non-compliance, advance disclosure of fees, of the adviser's role and recording on durable medium)?

(19) Credit intermediation has been highlighted recently as an area that will be particularly scrutinised by the Commission.[12] It will be addressed on a horizontal level and input will be sought on this in due course.

Early Repayment

(20) Early repayment of the loan is a crucial aspect of the mortgage credit bargain. The lengthy duration of mortgage contracts and the change of key contract conditions in this duration (e.g. interest rate changes) may motivate the consumer to seek a premature exit from the credit contract. Early repayment fees (ERFs) are the price to be paid by the consumer for this premature exit.

(21) Early repayment regimes vary widely across Member States. In some they are highly regulated and in others they are a matter of private contract law between consumer and lender, with the consumer only having a choice between different kinds of standard contracts and mortgages, as opposed to a real opportunity to negotiate individual terms. ERFs are generally attached to fixed interest rate mortgage products, protecting consumers against interest rate changes, with the fee applying to a departure during this 'fixed' period. ERFs are said to reflect the funding structures in place to support the product(s) on offer, and have a direct impact on competition and on product diversity and availability. They influence the transmission of macro-economic changes, that is, whether, to what extent and how changes in the base (interest) rate can affect mortgage debtors.

(22) The Commission considers that some level of consistency in the area of early repayment, notably on the imposition of fees, could facilitate integration. But how can such consistency be achieved without adversely affecting funding structures and the range of product choice, or disproportionately penalising consumers? The following questions merit close analysis:

[12] See footnote 3.

- Should early repayment be a legal right or a matter of choice? If it is to be a right, should it also be made possible for a consumer to waive this right? Under what conditions? Should this right be subject to a compensation in the form of fees?
- How should such fees (whether under a right or through contractual choice) be calculated? Should there be caps, as is the case in some Member States?
- How should the consumer be informed about early repayment? Is there scope for consumer education here?

Annual Percentage Rate

(23) The *Annual Percentage Rate (APR)* on a mortgage loan is another key factor, the effects of which persist for the duration of the contract. Calculation of mortgage *APRs* and the cost elements which enter into such calculations vary across Member States, making comparisons more difficult.

(24) Given the particular nature of such credit contracts in comparison with consumer credit contracts, it could merit a tailored approach. This is an area where it appears that some degree of standardisation could favour market integration. But many questions arise:

- What is the purpose of an *APR*? Information? Comparison? Both?
- Should there be an EU standard covering both the calculation method and the costs elements?
- If so, what kinds of cost elements should such an EU standard include?
- The Commission welcomes views on the merits of providing separately information on all costs not specified in the *APR*, and on the presentation of the effects of the *APR* in concrete terms such as the cost per month or the overall cost of the loan.

(25) Any decision here will be made taking due account of the regime which will be followed in the area of consumer credit.

Usury Rules and Interest Rate Variation

(26) Some Member States have legally enforceable caps on interest rates, often termed 'usury' rules where they are designed to prevent the charge of excessively high interest rates. The Commission has abstained from any intervention in this area, which involves important social considerations.

- What are the implications of usury rules for market integration (including any relationship with products such as *equity release* and mortgage insurance)?
- Should this issue rather be examined in a broader, non-mortgage specific, context?

(27) On interest rate variation caps, the Commission remains to be convinced on the extent to which they could hinder market integration or the development of particular funding structures.

(28) Finally, the Commission notes that some Member States impose restrictions on the imposition of compound interest rates.

- Do such restrictions hinder market integration?
- What impact can they have on the development of particular products such as *equity release* products?

Credit Contract

(29) Standardisation of contract terms, as recommended by the Forum Group, must be assessed in the broader framework of the Commission's European Contract Law initiative.[13] Standardisation could be achieved either by classical harmonisation or by way of a so-called 26th regime. This 26th regime could be introduced by a legal instrument sitting alongside, but without replacing, national rules, and available as an option to the parties to a contract. The Commission has undertaken to explore the merits of the 26th regime concept in its recent Green Paper on Financial Services Policy.[14]

The Commission welcomes views on the merits of the standardisation of mortgage contracts, e.g. via a 26th regime instrument.

Enforcement & Redress

(30) The Commission is mindful that traditional judicial redress mechanisms can be lengthy and costly for most consumers. It considers that any alternative means of redress such as mediation or arbitration must be independent and efficient in order to be trusted by consumers, particularly in a cross-border context. The Commission has already undertaken work to promote the use of mediation by proposing a Directive on aspects of mediation in civil and commercial matters.[15]

- Should the Commission consider imposing on Member States an obligation to ensure the existence of such alternative means of redress in the mortgage credit area?
- The Commission welcomes views on ways to reinforce the credibility of existing alternative redress systems, particularly in the mortgage credit area.

13 COM (2004) 651. European Contract Law and the Revision of the acquis: the way forward.
14 See footnote 3.
15 COM (2004) 718 final. Proposal for a Directive of the European Parliament and of the Council on certain aspects of mediation in civil and commercial matters.

III – LEGAL ISSUES

Applicable Law

(31) The 1980 Rome Convention, which governs the determination of the law applicable to contracts including mortgage credits, is currently undergoing a revision process in order to transform it into an EU Regulation. The Commission considers it advisable and consistent to address all issues of applicable law, including the law applicable to mortgage credit contracts, within the context of this process.

(32) As of today, at least three potential solutions have been identified within this process:

- Provide for a specific regime for the law applicable to consumer mortgage credit contracts in the future Regulation. This could consist of aligning the law applicable to the mortgage credit contract with the law applicable to the *collateral* contract.

- Continue to subject mortgage credit contracts to the general principles which, in the Rome Convention as it stands, would mean essentially that parties can freely decide on the law applicable to their contract, subject to the application – under some conditions – of the mandatory rules of the consumer's country of residence.

- Exclude the application to a consumer mortgage credit contract of the consumer's mandatory protection rules, provided that some conditions are met, for example that there is a high level of consumer protection in place at EU level.

(33) On the law applicable to the *collateral*, the Commission sees a priori no reason to depart from the well established principle that the law of the country in which the property is situated applies.

Client Credit-Worthiness

(34) Evaluation of client credit-worthiness, i.e. of the credit risk posed by the client, is a crucial aspect of the mortgage credit transaction, which could permit reductions in risk capital linked to higher levels of risk assessment by lenders. This is an area where data protection concerns are of paramount importance.

(35) Member States have different regimes for compilation of and access to credit-worthiness databases: public or private, centralised or decentralised, positive or negative (defaults only).

(36) There may be circumstances where arrangements for data sharing between lenders exclude some market participants in a way that could amount to a breach of EU law. In addition, access conditions may in effect discriminate against foreign lenders (e.g. membership or subscription rates which are not cost-effective for lenders not accessing databases with the same frequency as national lenders, or reciprocity rules requiring submission of relevant data as a pre-condition of access).

> Following the same approach as for consumer credit, the Commission considers that the priority could be to ensure cross-border access to databases on a non-discriminatory basis. It welcomes comments on this.

Property Valuation

(37) Valuation of property is central to the mortgage credit transaction and the way that it is used can directly affect the nature, the funding and the prudential rules applicable to the credit. Lenders, consumers and investors must have full confidence in the qualifications of the valuer, the valuation process and the resulting figure.

(38) Valuation traditions vary between Member States. There are currently several international valuation regimes.[16] The Commission considers that valuation comparability could be enhanced in order to ensure that such variety, which may be linked to genuine needs in domestic housing markets, does not inhibit cross-border activity on the lending or the funding side. Obviously this could be achieved by institution of a single standard, but the coexistence of competing but mutually recognised standards could fulfil the same objective.

- What are the merits of a single EU standard, for both valuation processes and valuers?
- What are the merits of Commission action to ensure mutual recognition of national valuation standards?

Forced Sales Procedures

(39) The *security* constituted by the *collateral* is a central aspect of mortgage credit transactions, as is the ability to *foreclose* the loan and call upon that *security*, e.g. through a forced sale of the mortgaged property.

(40) Forced sales procedures vary widely in duration and cost throughout Member States. The Commission notes the interaction with Member State housing and social policies, as well as the complex context of forced sales procedures which are affected by many diverse factors such as Member State laws, civil procedures and judicial traditions.

(41) The Commission is concerned that such variety could have the effect of hindering cross-border activity and perhaps adding to the price of the mortgage credit. More fundamentally, such variety could have a direct impact on funding structures, in particular by inhibiting the cross-border pooling of mortgage *collateral*.

(42) The Commission is nevertheless aware of the difficulties of achieving significant improvements on all aspects of forced sales procedures through binding EU rules.

The Commission seeks views on the following gradual approach to encourage improvements in forced sales procedures: to first collect information on the cost and duration of these procedures in all Member States and their effectiveness in protecting the interests of all involved, then present it in a regularly updated "scoreboard" and, should this prove ineffective in the long run, consider putting forward more robust measures.

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16 See footnote 28 in the Forum Group Report.

Tax

(43) The Commission takes action against national mortgage taxation rules which are not compatible with EU law. Annex I provides details of potential infringements such as the refusal of tax deduction for interest paid to foreign providers where interest paid to domestic providers would be tax deductible, or higher taxation of such interest.

The Commission seeks information on similar or other tax obstacles to the cross-border provision of mortgages, which are likely to infringe the freedoms provided for by EU law.

IV – MORTGAGE COLLATERAL

Land Registers

(44) Land registers record and to a certain extent determine legal property ownership rights. There is concern that such registers do not always reflect accurately all charges that could affect property ownership rights. An understanding of their contents and operation, as well easy access to them, is crucial for cross-border mortgage credit activity of any kind (including funding).

(45) This has already been recognised by the Commission through its funding of the pilot phase of the EULIS project[17], now concluded, which sought to enhance cooperation between owners and controllers of registers and facilitate cross-border access to them.

(46) The Commission questions whether it should continue to play an active funding role in such initiatives. Given the use of such registers by lenders and investors, one can assume that they would have a direct interest in contributing to and investing in such initiatives.

Before making further assessments, the Commission would welcome input on all these issues.

Euromortgage

(47) The idea of a Euromortgage is not new. It is an attempt to create an EU-wide instrument for *securing loans* on property, that is, for the mortgage *collateral*, which can be used in a flexible way. Its proponents argue that its central aspect – the weakening of the link ('accessoriness') between the mortgage *collateral* and mortgage credit – would facilitate the creation and transfer of mortgages, thereby having a beneficial impact on the mortgage credit market as a whole, in particular on its funding.

(48) The Commission is aware of market participant and academic led projects, aimed at designing a workable Euromortgage model in the form of a 26th regime.[18] The Commission will review how these initiatives propose to deal with such a complex

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17 See www.eulis.org for further details.

18 For example: "Basic Guidelines for a Eurohypothec", Mortgage Credit Foundation, Warsaw, May 2005.

issue, which touches upon many other related areas such as property law and contract law.

The Commission invites views on the feasibility and desirability of the Euromortgage. It will, in any event, await the outcome of ongoing initiatives to inform its assessment of this issue.

V – FUNDING OF MORTGAGE CREDIT

(49) Funding instruments in EU mortgage markets are diverse. Specific instruments such as *covered bonds* and *mortgage backed securities* play an important role in a pan-European as well as national context (for example UK *Mortgage Backed Securities*, Danish *covered bonds* and German Pfandbriefe).

(50) Many, in particular the Forum Group on Mortgage Credit, express the view that the further integration of the EU mortgage markets could be considerably enhanced by the emergence of a pan-European funding market.

(51) The Commission would tend to share this view. But this premise clearly merits further in-depth analysis. Pan-European funding mechanisms have the potential to increase sources of funding, deepen the liquidity of the market and more generally allow for the diversification of risk. Further integration of the *secondary markets* in loan funding is linked to the integration of the *primary market*. A key aspect that cuts across both areas is transferability of mortgage loans.

• The Commission intends to create an ad hoc stakeholders working group to examine the need for and nature of action on the funding aspects (primary and secondary) of mortgage credit. • It is interested to assess to what extent a pan-European market in mortgage funding can be promoted by market led initiatives, e.g. on documentation standards and model definitions to be used in cross-border funding activities.

(52) The Forum Group and other sources predict the growth of non-deposit based mortgage loan funding mechanisms.

In this respect, the Commission is interested to receive views on whether mortgage lending should necessarily be an activity which is restricted to credit institutions, or whether and under which conditions such activity could be performed by institutions which do not take deposits or repayable sums, and therefore do not fall within the scope of the EU definition of a credit institution and therefore of all related prudential rules.

ANNEX I – RESPONSE TO GENERAL FORUM GROUP RECOMMENDATIONS

This Annex contains the Commission's views on issues addressed in the Forum Group Report, which do not fall within the scope of the four areas covered by the Green Paper.

Definition of cross-border lending

(1) The Commission is not clear as to why this definition is needed. It assumes that it would be useful for the purpose of measuring integration. The Commission considers that there is cross-border lending whenever a service crosses a border, be it through free provision of services, through an establishment (branch or subsidiary) or via an agent.

Research on the costs and benefits of further integration

(2) The Commission has already recognised the merits of such a course of action. It has commissioned an independent study on the costs and benefits of further integration of the EU mortgage credit markets. This study has delivered interim results, which have been taken into account in the formulation of this Green Paper. The final study will be published by the Commission in August 2005.[1]

On-line guide on mortgage lending

(3) Such a project would be very time and resources consuming. Moreover, it would not seem to be the Commission's role to provide information and indeed guidance on complex legal issues on which there can be conflicting views. However, the Commission will ensure that any useful information on mortgage credit (such as studies, reports etc.) available to it, and which can be publicised, is placed on its website.

Exclusion of all secured loans from the Consumer Credit Directive proposal

(4) It is intended that all loans secured on property by a mortgage or a similar surety, regardless of their purpose, will be excluded from the Commission proposal for a Directive on Consumer Credit. Therefore, such loans will be covered by any initiatives resulting from the process of which this Green Paper forms part.

Legislative consistency, especially in relation to information requirements

(5) Consistency in regulation is one of the major themes in the post FSAP era, as illustrated in the recent Green Paper on Financial Services Policy[2] which highlights rationalisation of information requirements in EU legislation as an issue to be addressed. The Commission has launched work on a Common Frame of Reference in the area of European Contract law.[3] Its purpose is to ensure increased consistency within the existing and future contract law related acquis, including on information requirements.

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1 See footnote 1 in the body of the Green Paper.
2 See footnote 3 in the body of the Green Paper.
3 See footnote 13 in the body of the Green Paper.

Banking Services

Branches

(6) Banking services can be provided on the basis of a harmonised framework establishing equal conditions of treatment for domestic and foreign EU credit institutions. The Commission takes action if such provisions are contravened. Any instances of unequal treatment in this regard should be reported to it.

Representative Offices

(7) As far as the Commission is aware, there are no barriers to the establishment of purely representative offices. However, representative offices cannot conduct banking business. If they do, they fall within the regulation of branches, on which see paragraph 6 above.

Tax

(8) Member States are free to determine their own rules on mortgage taxation, in the absence of any harmonisation in this area. The Commission has no plans to propose such harmonisation. However, when designing mortgage taxation rules, Member States have to respect their obligations under EU law, and the Commission will take action where it believes that EU law is infringed.

Higher taxation of foreign mortgage providers

(9) Since the publication of the Forum Group Report, the Commission has launched an infringement procedure concerning national rules which tax outbound mortgage interest payments more heavily than domestic mortgage interest payments.

(10) In the case at issue, no withholding tax is levied on interest paid to resident financial institutions. The interest they receive is subject to national corporate income tax. This means that domestic providers pay tax on the net interest they receive, that is, the interest they receive minus the interest they paid to acquire the necessary capital. By contrast, non-resident financial institutions are subject to a withholding tax on the gross amount of the interest due. The withholding tax on outbound interest payments may be considerably higher than the corporation tax on domestic interest payments.

(11) The Commission is of the opinion that such national rules restrict foreign financial institutions from offering their services in the Member State concerned, and the Commission does not see a justification for such rules. They therefore appear to be contrary to Articles 49 and 56 of the Treaty (and the corresponding EEA Treaty provisions) on the freedom to provide services and the free movement of capital.

Deductibility of mortgage interest

(12) Another issue is the tax deductibility of mortgage interest payments. A number of Member States allow their residents to wholly or partially deduct mortgage interest payments from their taxable income. It should not make a difference whether the mortgage interest is paid to a domestic provider or to a provider established in another Member State, as this would be contrary to Articles 49 and 56 of the Treaty (see Case C-484/93 of 14 November 1995 and Case C-478/98 of 26 September 2000).

Internet

(13) Physical presence and/or written processes are still prevalent in mortgage credit transactions. The Internet tends to be used mainly for seeking information and compare products. There is little if any actual contracting on-line in most Member States. However, as far as the Commission is aware, the provisions of the E-Commerce Directive[4] and related legislation have addressed the main legal barriers to concluding such contracts on-line.

4 Directive 2000/31/EC of 8 June 2000, OJ L178 of 17.7.2000 p.1.

ANNEX II – TEXT OF FORUM GROUP REPORT RECOMMENDATIONS

INTRODUCTION

1. The Commission should adopt a definition of cross-border lending and monitor it with statistical data.

CONSUMER CONFIDENCE

Common Recommendations

2. There should be Commission funded research on the costs and benefits of further integration of the mortgage credit market.

3. Provision of the kind of information currently provided by means of the European Standardised Information Sheet created by the Code of Conduct should be encouraged by the Commission and at a stage which facilitates use and comparison of such information.

4. Consumer Representatives and most Industry Representatives advocate harmonisation by the Commission of Early Repayment Fees. There is divergence on the nature of such harmonisation. For further details see Recommendations 10 and 18.

5. There should be harmonisation by the Commission of the Annual Percentage Rate Charge (APRC), in relation to both the method of calculation and the basis of calculation. There is divergence on the nature of such harmonisation. For further details see Recommendations 11 and 16.

6. There should be Commission funded research on the value from a consumer perspective of pre-contractual information of the kind provided by the European Standardised Information Sheet created by the Code of Conduct.

7. The Commission should create and maintain an on-line guide on the main legal and other issues on cross-border mortgage lending.

Specific Consumer Representative Recommendations

8. The Commission should encourage efforts to produce a standardised format for mortgage loan contracts.

9. The Commission should introduce binding consumer protection rules for mortgage loan contracts on a minimum harmonisation basis, set at the highest level, covering the following areas:

   - Duty to give ‘best possible advice’. The demands and needs of consumers and the underlying reason for all mortgage credit advice given to consumers regardless of source (including branches and intermediaries) should be specified to consumers on a durable medium.

   - The right of the consumer to redress (judicial and extra-judicial).

- The provision of pre-contractual summarised information at the earliest stage of contact between the consumer and the lender or intermediary showing in a standardised European Standardised Information Sheet type format: commission charges, administration or handling charges, total amount borrowed and payable (including APRC, calculation rate, compound period, operation of variable interest rates and total interest payable), the cost of bundled products (direct and the impact on interest), form of product, the exposure period and cost of the Early Repayment Fee (including worked examples of the charge) and amortisation tables.

10. The Commission should ensure that consumers are afforded the right to terminate a mortgage agreement at any time and in any circumstances. Any charge levied on the consumer seeking to exercise this right must be: (a) appropriate in length of exposure (i.e. Early Repayment Fee charged beyond the first few years of the agreement must not be allowed); (b) calculated in a fair and objective manner to reflect the cost (if any) incurred by the lender in the wholesale markets and subject to a statutory ceiling; and (c) clearly indicated in the pre-contractual summary document using worked examples.

11. There should be harmonisation by the Commission of the Annual Percentage Rate Charge, in relation to both the method of calculation and the basis of calculation. Consumer Representatives favour a broad definition including all associated charges, and minimum harmonisation.

12. The Commission should ensure that redress and enforcement mechanisms/binding rules offer consumers a minimum equivalent protection throughout the EU, at the very least at the highest level currently in existence.

Specific Industry Representative Recommendations

13. The Commission is invited to exclude all secured loans from the Consumer Credit Directive proposal, in line with the European Parliament First Reading, to ensure that mortgages are not subject to two separate legal regimes.

14. In those jurisdictions which have binding rules on pre-contractual information for mortgage credit offers, the Commission should ensure that such rules are aligned with the European Standardised Information Sheet format, so that only one set of rules apply.

15. The Commission should ensure that the Code of Conduct continues to be maintained, in its current form of self-regulation. In any event, before any further assessment of its operation, the methodology for such assessment should be discussed by all stakeholders.

16. The Commission should harmonise the Annual Percentage Rate Charge, in relation to both the method of calculation and the basis of calculation. Industry Representatives favour a narrow definition restricted to costs levied by the lender for its benefit at the time of the granting of the loan, and full harmonisation.

17. The Commission should ensure that legally enforceable caps on interest rates and on the variation of interest rates are removed.

18. The Commission should ensure that legally enforceable caps on Early Repayment Fees are removed. There is support amongst some Industry Representatives for a proposal that there should be full harmonisation of the conditions for exercising the right of early repayment, especially for fixed interest rate loans, and limitation of that right to circumstances involving sale of the property, unemployment or death. All Industry Representatives advocate that lenders should be entitled to ask for full compensation of losses (especially those linked to funding) and costs resulting from the early repayment.

LEGAL ISSUES

19. The Commission should ensure that the applicable (substantive) law for the mortgage deed and any related security agreement is the law of the Member State where the property is located (lex rei sitae).

20. Industry Representatives advocate that the Commission should ensure that the applicable law for the mortgage loan contract is defined by a general conflict of law rule based upon the principle of free choice. The Rome Convention should be amended accordingly, provided that certain essential standards are met. Member States should no longer be able to seek to impose any additional national consumer protection rules to cross-border mortgage loan contracts. For further details see Recommendations 13–18 on Consumer Confidence.

21. Consumer Representatives do not agree with Recommendation 20 that the applicable law for the mortgage loan contract should be defined by a general conflict of law rule based on the principle of free choice and accordingly reject the proposal for such an amendment of the Rome Convention. Instead they recommend the retention of the specific rules on consumer protections contained within the Rome Convention and advocate the additional protection described in Recommendations 8–12 on Consumer Confidence.

22. The Commission should implement a short-term solution consisting of:

- collecting information on existing credit databases in all Member States;
- promoting the development of a Memorandum of Understanding between the owners/controllers of such databases, to facilitate access to national databases by foreign lenders on the same conditions as the access offered to domestic lenders and to facilitate data comparability; and
- developing a project to assess the effectiveness of the Memorandum of Understanding during a pilot phase of 3–5 years.

23. The Commission should consider how to encourage Member States to develop positive (client indebtedness) as well as negative (level of default(s)) databases, taking into account the costs and benefits of such databases.

24. Industry Representatives advocate that the Commission should ensure that a financial institution which lends cross border is allowed to:

- accept valuations prepared according to internationally recognised valuation standards of its choice, without being subject to additional national conditions; and

- instruct any valuation practitioner who is a member of an internationally recognised valuation body to carry out the valuation, without being subject to additional national conditions.

25. Industry Representatives advocate that the Commission should ensure that a financial institution which lends cross border, and the valuer based in the country where the property is located, are able to accept mandatory regulations for standards or practitioners prevailing in either of their respective countries (mutual recognition of regulations).

26. Consumer Representatives advocate instead that the Commission should ensure that neutral international valuation standards prevail, or that there exists a single valuation standard ensuring comparability.

27. The Commission should recommend that high standards of valuation be made mandatory and that all valuation reports should consider core risk related criteria such as those recommended by the European Mortgage Federation (set out in Annex IV of the Forum Group Report) where applicable.

28. The Commission should first:

    - Perform an evaluation exercise of forced sales procedures within one year.

    - Thereafter, monitor the functioning of forced sales procedures and assess results every three years. These results should be presented in the form of an official EU scoreboard on duration and cost of forced sale procedures in every Member State and lead to Commission advice/action for improvements.

29. Thereafter, if necessary, the Commission should promote measures to ensure that the duration of a forced sale procedure should not exceed a specified term, for example two years after the first step in the forced sale procedure.

COLLATERAL ISSUES

30. The Commission should ensure that:

    - all charges affecting real estate must be registered in a Public Register in order to be binding on and take effect against third parties, regardless of their nature;

    - the creation, modification or extinction of a charge on real property shall become effective vis-à-vis third parties only at the point of registration in the Public Register; and

    - registered charges on real property in relation to the same estate shall rank in the order of priority disclosed in the Public Register.

31. For filings of applications for registration/notification, the Commission should allow Member States to decide that priority be determined according to the time at which

the application was received (not actual registration). In this scenario, the Member State should ensure that filings of applications must be registered or rejected by the Public Register in the order of receipt.

32. The Commission should ensure that Public Registers make all relevant information available to all parties or their representatives.

33. The Commission should ensure that Member States provide that the responsible Public Register certifying authority should have state indemnity. In the event that such responsibility is delegated to a third party, such party shall be covered by appropriate professional liability insurance for an adequate sum.

34. The Commission should ensure that Member States do not maintain or institute additional 'legalisation'/'validation' requirements, for authentic instruments formally drawn up in other Member States.

35. More generally, the Commission should provide financial support to the EULIS initiative, to enable and encourage its expansion across the EU.

36. The Commission should ensure that links between mortgage debts and the collateral security are made more flexible. In countries where there is an existing requirement for strong accessoriness between the loan and the collateral, this should be replaced by an accessoriness agreement in the form of a private agreement between the lender and the owner of the mortgaged property. The relationship between the loan and the collateral can be dealt with in such a way as to allow it to be tailored to fit the needs of the parties.

37. The Commission should ensure that Member States allow the lender or any beneficiary of a charge on real property, to appoint a representative (Mortgage Register Representative) vis-à-vis the Public Register. His/her position should be disclosed on the Register and not have any effect on the legal framework of the Register. He/she should be entitled:

- to establish any abstract of title;
- to consent to a change in the respective ranking of charges over the real estate in question and to grant preferential rights between beneficiaries as shall be deemed appropriate;
- to consent to, apply and file any registrations and notifications;
- to consent to any change or transfer of the charge on behalf of (and in the name of) the owner of the charge; and
- to act on behalf of the owner of the charge in relation to the discharge or cancellation of the charge.

38. The Commission should explore the concept of the Euromortgage, for example by way of a study, to assess its potential to promote EU mortgage credit markets integration.

39. The Commission should encourage Member States to increase the transferability of mortgages by introducing pan-European Security Trust instruments.

DISTRIBUTION ISSUES

40. The Commission should assess and ensure equal treatment of local banks and foreign banks on the basis of the same business, same risks, and same rules principle.

41. The Commission should revise the legislation covering cross-border services and establishment of branches to include the establishment of representative offices, in order to ensure that there are no disproportionate barriers to the establishment of such offices.

42. The Commission should introduce a supervisory system for independent intermediaries along the following principles: registration with a competent authority in the home Member State; possession of appropriate professional knowledge and ability (to be determined by home Member State including requirement that the intermediary to be 'fit and proper'); possession of professional indemnity insurance and a complaint/redress scheme in line with requirements for other intermediaries to ensure consistency. In addition, Consumer Representatives advocated that under such a system there should be declaration at the outset of the relationship between consumer and intermediary of all payments including every commission/fee, and that records should be kept of any information/advice given to consumers. In the context of this Recommendation, Consumer Representatives pointed to the need to consider their Recommendation 9, in particular, with its reference to a 'best advice' standard.

43. The Commission should review what mortgage transaction actions require written processes and/or a physical presence generally and review money laundering legislation in particular, to address current legal barriers to greater Internet use.

44. The Commission should ensure consistency, especially in relation to information requirements, between different directives affecting financial services products.

FINANCE

45. The Commission should harmonise legislation regarding segregation of assets, in order to ensure equal access to securitisation for originators located in different jurisdictions.

46. The Commission should enact legislation that recognises the legal separateness of a securitisation vehicle from an originator of assets in the event of the insolvency/bankruptcy of such an originator, even if the securitisation vehicle is part of the same group of companies as the originator.

47. The Commission should investigate and address tax distortions, in order to ensure the removal of differences in fiscal treatment between local and foreign lenders.

48. The Commission should investigate and address national legislation which prevents or hinders the pooling of mortgage collateral from different issuers based in different jurisdictions.

ANNEX III – GLOSSARY

This glossary is not intended to constitute a conclusive Commission endorsed definition of the terms contained within it. The definitions have been provided by the European Mortgage Federation. They are attached to this Green Paper simply by way of an illustration of some technical terms used within it.

Annual Percentage Rate (APR)

A standardised method of calculating the cost of a mortgage stated as a yearly rate, which includes items such as interest, mortgage insurance, and certain points of credit costs.

Bond

Traditionally, a written unconditional promise to pay a specific principal sum at a determined future date and interest at a fixed or determinable rate on fixed dates. Increasingly, the promise to pay has become conditional and the principal, interest and payment dates have become contingent in real world instruments.

Capital Markets

The markets for corporate *equity* and intermediate- or long-term debt securities.

Collateral

The property, or other assets, that are being secured against a loan to ensure repayment of debt.

Covered Bond

Covered bonds are on balance sheet debt instruments secured by a cover pool of mortgage loans (property as *collateral*) or public-sector debt to which investors have a preferential claim in the event of the issuer's default. As they remain on the issuer's balance sheet, the *bonds* benefit from the additional security of the issuing institution's own funds and from restrictive legal regulation of the issuing credit institutions.

Equity

Shareholder equity is the value of shares held. A house owner's equity is the value of the house minus any unpaid home-purchase loan. Negative equity occurs when the house is worth less than the debt on it.

Equity Release

Equity Release is a mechanism to turn the cash value of a house into a stream of income and capital payments.

Equity Release Loans

Secured (mortgage) loans taken out for consumption purposes.

Foreclosure

The legal process by which a borrower in default under a mortgage is deprived of his or her interest in the mortgaged property. This usually involves a forced sale of the property at public auction with the proceeds of the sale being applied to the mortgage debt.

Loan-to-value (LTV) Ratio

The ratio of the mortgage loan amount to the property's appraised value or selling price, whichever is less. For example, if the property's appraised value or selling price is 100 000 Euro and the mortgage amount is 80 000 Euro, the house has an 80% LTV.

Mortgage Backed Security

Debt instruments collateralized by residential, commercial, or industrial real estate mortgages.

Mortgage Bond

A corporate or other entity's debt *security* secured by a mortgage lien against certain real property of the issuer. See definition for "*covered bond*".

Primary Mortgage Market

A mortgage market in which loans are originated and consisting of lenders such as commercial banks, savings- and loan associations and mutual savings banks.

Secondary Mortgage Market

A market where mortgage originators may sell them, freeing up funds for continued lending and distributes mortgage funds nationally from money-rich to money poor areas.

Secured Loan

A loan that is backed by *collateral*.

Security

Something given, deposited, or pledged to make secure the fulfilment of an obligation, usually the repayment of a debt.