



EUROPEAN COMMISSION

Internal Market and Services DG

FINANCIAL INSTITUTIONS

Retail issues, consumer policy and payment systems

Brussels, **20 December 2006**

MORTGAGE INDUSTRY AND CONSUMERS EXPERT GROUP FINAL REPORT

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1. INTRODUCTION

In April 2006, DG Internal Market and Services and DG Health and Consumer Protection launched the Mortgage Industry and Consumer Expert Group ("Mortgage Dialogue") to explore to what extent common principles on four key consumer protection issues, namely: information, advice, early repayment and annual percentage rate (APR), could be agreed upon. Wherever possible, the discussions were to move beyond general principles and try to arrive at commonly acceptable standards.

Industry was represented by EBIC and consumers were represented by BEUC, Euro Coop and COFACE.

The Mortgage Dialogue met eight times during 2006. This report summarises the discussions held, and presents the main conclusions. These conclusions reflect the positions expressed by the parties during meetings, but do not necessarily commit their federations/associations, the proper consultation of which could not always be ensured due to the tight deadlines that parties were working under.

The views expressed in this report cannot in any way be attributed to the Commission, whose role was to host the meetings, facilitate the debates and suggest compromise proposals to the parties whenever appropriate.

2. PRE-CONTRACTUAL INFORMATION

Pre-contractual information is currently subject to a European Code of Conduct adopted in 2001. In the Green Paper consultation, several respondents made proposals to modify the European Standardised Information Sheet (ESIS) either by modifying existing items or by adding additional items.

The Mortgage Dialogue was asked to consider the content and format of pre-contractual information as well as the moment at which pre-contractual information should be provided to the consumer. Possible means to ensure proper monitoring and enforcement of the Code of Conduct were also briefly discussed.

2.1. Timing of Pre-contractual Information

The Code of Conduct does not specify when the pre-contractual information has to be given to the consumers. This is often presented by certain stakeholders as one of the Code's weaknesses. Pre-contractual information is provided at different moments depending on national practices. For example, in some countries, the ESIS is provided before the offer and, in other countries, it is provided together with the offer.

The Mortgage Dialogue explored the feasibility of defining a point in time for the provision of both general and personalised pre-contractual information.

In general, it was felt that defining a precise moment in time for the provision of pre-contractual information would be impossible, given the significant diversity of national practices. Discussions rather focused on the possibility to define a period, rather than a given date, and on the finality (in terms of information and comparison) of the provision of the ESIS.

2.1.1. General pre-contractual information

A consensus emerged that general information should be provided by the lender to the consumer at the earliest opportunity and, in any event, before the consumer is requested to provide the personalised information necessary to complete the ESIS.

2.1.2. Personalised pre-contractual information

Discussions on when the ESIS should be provided were more inconclusive.

A consensus emerged over the fact that the ESIS *"should be given without undue delay after the consumer has given the necessary personal information and, in any event, before the conclusion of the contract, enabling the consumer to use the information contained in the ESIS in order to compare the offers available on the market, to assess the implications of the product considered and to take a decision"*. Industry insisted on the fact, however, that nothing in this principle should require lenders to offer advice to consumers.

Parties agreed in principle that, where the ESIS is provided to the consumer together with a loan offer, the consumer shall have *"sufficient time to compare offers"*.

Consumer representatives, with the exception of Euro Coop, were of the view that the notion of "sufficient time" should mean at least 14 calendar days, under which consumers would have the option to sign at any given time without having to wait for the 14 days' period to elapse, but the lender will be tied to its offer for at least 14 calendar days, to allow consumers to effectively be in a position to shop around for the best deal. Euro Coop, although agreeing that further clarification would be beneficial for consumers, considered that it was not necessary to set a fixed period of 14 calendar days. The introduction of a 14-day period was not supported by EBIC, which, after having consulted its members, concluded that the high diversity of loan granting processes made it impossible for a common timing to be introduced across the EU. Industry stated that, as such, the introduction of a 14-day period would therefore neither reflect nor be compatible with the diversity of current national practices, i.e. the 10 days reflection period in France, a concept which does not exist in any other Member State. Also, in their view, a defined timing of such a length would be to the detriment of those consumers who wish to conclude the credit agreement earlier than the 14-day period. Finally, according to industry representatives, this set time period would introduce an element of standardisation, when in fact this aspect should be left to the market in order to allow for competition.

Furthermore, consumer representatives insisted on the fact that the consumer shall not be pressured by the lender into making a precipitous decision. Industry opposed this statement which, in their view, would imply that mortgage lenders do use pressure selling on their customers. However, EBIC representatives proposed instead the principle that ESIS should be provided to consumers sufficiently early in order to prevent them from taking precipitous decisions.

Consumer representatives made a link between the ability to compare and the costs. They insisted on the fact that the ESIS should always be provided free of charge to make it a genuine tool for comparison, and at the earliest possible stage (for example at the first visit in Belgium). The problem may, according to consumers, arise in countries where the ESIS is handed out with a binding offer and when, at this stage, the consumer has already had to face some costs or a commitment to do so, for example, for valuation purposes. The fact that the consumer has already been exposed to costs would limit the consumer's willingness to shop around since, potentially, he might incur similar costs with another lender. Only if these conditions are met is the general principle that, where the ESIS is provided together with a loan offer, the consumer shall have "*sufficient time to compare offers*" acceptable to BEUC.

Discussions were not conclusive on this point. Consumer representatives underlined that it needs to be ensured that consumers are in a position at this stage to effectively compare and contrast offers, and to shop around for the best deal. Euro Coop argued that, although the cost issue is important for consumers, it is not directly linked to the question of timing for pre-contractual information and it should not be an obstacle for a compromise agreement on the matter. According to EBIC representatives, offers (including binding ones) are generally given for free, subject to verification of the property valuation (if needed). The property valuation would be done (and paid by the consumer) only after he has signed the contract.

2.2. European Standardised Information Sheet (ESIS)

2.2.1. Content

Consumer representatives emphasised the need to improve the ESIS. The Code of Conduct being a flexible instrument, the mortgage lending industry confirmed that it was prepared to consider changes to the ESIS provided that there was evidence of a benefit for consumers. Consumer organisations highlighted the evidence included in Annex II of the Forum Group Report, in addition to their own experience in that matter.

Consumer representatives presented a list of possible modifications to the current ESIS. In some cases, these modifications were inspired by an existing model, provided by the UK Financial Services Authority, called "Key facts Illustration" (KFI). These modifications included proposals to enhance consumers understanding of the information, such as through the provision of "risk warnings", and proposals for additional items, for instance on the right of withdrawal or on the total cost of the credit.

Although EBIC considers the ESIS in its current form to be well designed and balanced, EBIC is open to a revision of certain aspects. Industry noted that despite it not having requested such modifications itself, there was an understanding that a number of consumers' requests, such as on risk warnings or foreign currency loans, were reasonable. The Industry however insisted that the outcome of the discussions on the revision of the ESIS should not lead to information overload.

Although a final agreement on a revised ESIS was not reached, progress was made on certain items. A consensus began to emerge on possible changes to some existing ESIS items like "Description of Product" and "Amount and currency". In general terms, the idea of "risk warnings" was also received rather positively. Divergences remained on items like "Nominal rate" and "Additional non-recurring costs", and on proposed new items such as "Total cost of credit", "Right of withdrawal" and "Consequences in case of non-compliance".

More work would still be required to reach tangible compromises. In industry's view, the revision of the ESIS needs to be discussed further to reach an appropriate and well balanced result.

2.2.2. Format

Consumer representatives suggested modifying the order of ESIS items, in order to group items relating to the same issues (costs for example) and improve the legibility of the ESIS. However, genuine discussions on a new different ordering could not take place, since it would have required prior agreement of the substance.

2.3. Code of Conduct: Enforcement Mechanisms

Since the release of the "IFF study" on the implementation of the Code of Conduct in 2003, consumer representatives have repeatedly criticised the absence of credible enforcement mechanisms in the Code of Conduct. Consumer representatives have expressed strong reservations as regards the efficiency of Codes of Conduct generally, partly due to failed experiments at national level.

Parties of the Dialogue were invited, without prejudging the future of the Code, to review possible monitoring and enforcement mechanisms to improve compliance with the Code.

Consumer representatives argued that the improvement of the Code of Conduct and of its functioning is not the best solution and that there is no convincing alternative to binding rules (this should not call into question the current high level of consumer protection in place at the national level). For consumer organisations, therefore, the Code of Conduct needs to be made binding for all lenders. BEUC stated that redress should be available to consumers in case of failure to implement the information requirements and concrete penalties should be set (e.g. absence of interests to be paid as is already the case in Belgium for consumer credits if a higher interest rate than the maximum one authorised is requested).

Industry representatives stated that they had always made it clear that they support Codes of Conduct generally and the European Code of Conduct for Home Loans (the Code) more specifically. Industry argued that it had repeatedly asserted that it strongly favours maintaining the Code – which is now implemented in 19 Member States – under its current (voluntary) status, improving its efficiency and facilitating its application to all of the EU Member States. In industry's view, the introduction of binding legislation would significantly undermine self-regulation and would negate the industry's enormous efforts and investments to implement and apply the Code. Industry emphasized that in contrast to difficult legislative procedures, the Code is a flexible instrument, which can be modified quickly and easily to respond to national and European developments. Furthermore, industry was of the view that the Commission's scoreboard on the implementation of directives shows that introducing legislation would neither have been any quicker nor more efficient.

Consumer representatives presented the UK "Banking Code Standards Board" as perhaps the most successful monitoring and enforcement mechanism to date, highlighting however that it does not imply per se that it is successful enough, as a number of caveats remain (lack of basis for adequate compensation in case of non compliance, weak enforcement measures: "naming and shaming" only).

Industry representatives were sceptical about the creation of a European or national compliance board and questioned its feasibility due to the complexities involved, i.e. the handling of 20 (soon to be 23) languages, the legal nature of a compliance board, the nature of its composition, the status of its decisions (binding or not), the possibility (or not) for the borrower to appeal, the law applicable etc. Instead, EBIC argued that lender's existing own internal compliance mechanisms were sufficient. According to industry representatives, should this prove ineffective, a national ombudsman scheme, for example run by national mortgage lending associations as it is the case in Germany, could be considered. BEUC representatives rejected the idea of an ombudsman scheme run by national mortgage credit associations and contested that such a scheme exist in Germany.

More generally, EBIC stressed the fact that it would be useful to investigate more in-depth the mechanisms (legal, ombudsmen schemes etc.) currently existing in Member States as regards enforcement mechanisms as well as the pending implementation of the Unfair Commercial Terms Directive.

No consensus between parties emerged on this issue.

3. ADVICE

Parties to the Dialogue were asked to assess what advice is; whether the provision of advice should be compulsory or optional; to consider whether advice should be a separate service or should be part of the information provided by a lender; and to reflect on who should give advice (lenders, specialised advice providers etc.). In addition, parties were asked to explore some principles relating to the concept of advice.

3.1. Scope and Definitions

Discussions showed that there is a certain ambiguity about the definition of what constitutes "advice" and, in particular, on how to draw a line between "information" and "advice". In order to clarify the issue and to facilitate the discussions, both sides were asked to reflect on possible definitions. In the course of discussions, industry confirmed that it is its understanding that – in face to face situations between consumers and lenders – information does contain certain elements of explanation and clarification. Based on contributions submitted by industry and consumers, the Commission proposed definitions of the notions of "information", "advice" and "risk warning". These definitions were solely used as working tools, to facilitate the discussions, and do not have any legal value.

"Information" was defined as a description of a given product, either in general terms or in a more specific way. It implies that explanations/clarifications be given to the consumer about the information received.

"Advice" was defined as a recommendation of one or more financial products given to an individual consumer, taking into account his specific situation.

"Risk warning" was defined as a call for caution from the lender to a consumer, in order to make him aware of the potential risk connected with a given financial commitment. A *"general risk warning"* would aim at making all potential borrowers aware, irrespective of their specific situation, that changes in their personal financial situation (e.g. fall in income) or in the economic environment (e.g. rise in interest rates) may have implications on their ability to repay. A *"specific risk warning"* would be given in a situation where a lender warns a particular borrower against the risky nature of a planned credit, in the light of his specific situation (resources, work situation etc.).

3.2. Compulsory or optional "advice"

No compromise emerged between the parties on the question as to whether the provision of "advice" should – or should not – be mandatory. EBIC held the view that "advice" should remain a separate, "tailor-made" service and that, if provided, it should be on request and against remuneration. Consumer Representatives, with the exception of Euro Coop, supported the introduction of a compulsory duty for lenders to provide advice. They also highlighted the need for 'best possible advice' to be provided. Euro Coop agreed with EBIC that advice should be a separate service, but also stated that, if provided, advice should be regulated in detail.

3.3. Principles

In the light of the general disagreement on the question as to whether or not the provision of "advice" should be obligatory, the Dialogue members examined some basic principles identified by the Commission as relevant to the discussion on advice. Some of these principles reflected common views between the parties, whereas others, also discussed during the Dialogue, proved more problematic. Consumer representatives highlighted that these common principles should not call into question the current high level of consumer protection in place at the national level.

Both sides could agree in principle, on the following statements:

- (1) A consumer is entitled to receive complete and accurate pre-contractual information, including explanations on the characteristics of a product and on the effects these characteristics may have on the consumer;
- (2) The lender is expected to assess the creditworthiness of the consumer in the context of the transaction envisaged;
- (3) The consumer is expected to provide in good faith all relevant information asked for by the lender in order to perform his creditworthiness assessment;
- (4) It is the consumer who makes the final decision to accept or reject an offer;
- (5) The lender is expected to provide general "risk warnings" in the pre-contractual material (such as the European Standardised Information Sheet);
- (6) The lender is expected to give specific "risk warnings" in special situations (e.g. to financially vulnerable consumers) or upon request of the consumer.

Parties also discussed the principle of whether or not a lender should lend to a consumer in situations in which the lender considers that a loan would be too risky for the consumer.

EBIC pointed out that, firstly, lenders do not as a principle grant a loan if – based on a creditworthiness check – they come to the conclusion that the candidate borrower will not be able to meet his repayment obligations. Secondly, in industry's view, although sub-prime products present a higher risk of default as a portfolio, a huge majority of these borrowers do nonetheless repay their loan. EBIC stated that lenders would not grant a loan if they did not consider that it was affordable for the borrower on an individual basis.

Consumer representatives strongly supported this principle and did not consider that the sub-prime borrowers market would be affected. Consumer representatives stated that as sub-prime consumers are potentially faced with the highest interest rate, they are most at risk of facing difficulties in reimbursing the loan contracted. They noted that responsible lending principle is already a binding obligation in a number of Member States, e.g. the UK. COFACE stated that responsible lending must take account of the risk of over-indebtedness.

EBIC regretted the lack of clarity concerning the very finality (binding or otherwise) of the above principles.

4. EARLY REPAYMENT (ERP)

Early repayment regimes differ considerably between Member States. In some, it is compulsory, whereas others leave it to the contractual parties to decide. The Mortgage Dialogue considered several aspects to the early repayment debate: whether early repayment should be a contractual option or a legal right; whether consumers should be able to waive this right, and under which conditions; whether the creditor should be entitled to claim early repayment fees and, if yes, in which circumstances, based on which calculation method and with or without caps.

4.1. Legal right/contractual option

The mortgage lending industry, for its part, was in favour of early repayment being left to contractual freedom, and not being a legal right. Industry stated that the introduction of a right would not only potentially impact on prices and product diversity, but could also imply potential systemic risks in the event of mass early repayments in times of falling interest rates. Should a right to early repayment be granted, allowing for a waiver was deemed essential by mortgage lenders.

Consumers favoured introducing at EU level a legal right to early repayment. Consumer representatives contested industry's view that introducing a legal right to early repayment would result in a reduction in product diversity, and highlighted that the ability of lenders to refinance and the enhanced market dynamism/competition would mitigate any potential costs. Consumer representatives also opposed allowing consumers to waive their right to early repayment generally (should they have any such right), since, in their view, consumers are very unlikely to be in a position where they can negotiate with the lender the general contractual conditions of the mortgage on offer. Consumer representatives argued that there is a very strong incentive for lenders to tie in consumers with a mortgage credit in order to cross-sell other products, preventing consumers' mobility and jeopardising competition and restricting market entry. Consumer organisations rejected the argument of potential systemic risks in the event of mass early repayment. Consumer representatives stated that experience in Denmark is in sharp contradiction with this assertion, as the Danish mortgage system has handled a substantial refinancing of mortgage credits in periods of falling interest rates without any problems. Consumer representatives also noted that, in any case, the current level of consumer protection at national level shall not be called into question.

4.2. Compensation

Parties agreed on the principle that lenders should receive a compensation when a consumer repays his loan earlier than at its contractual termination. BEUC clarified that in their view this should only apply in the case of fixed interest rates, whilst no compensation would be applied in the case of variable interest rates. Furthermore, parties agreed that any compensation, if applicable, should be calculated in a "*fair and objective*" manner.

There was, however, no agreement on what could be considered as "fair and objective". In the view of consumer representatives, "fair and objective" should only reflect the actual cost borne by the lender, but not the potential losses in terms of foregone revenues since losing future income must be considered as a normal business risk and receiving compensation on foregone servicing profit would necessarily limit competition. Consumer representatives considered that compensation under the Danish system fulfils the conditions of 'fairness and objectivity'. Without the Danish system being called into question, consumer representatives supported limits on compensation (payable within a limited time frame of the life of the contract, caps on the amount).

Industry opposed any such caps, arguing that only a full reimbursement of the lender for all his losses, on a Yield-Maintenance-Indemnity basis¹, could be considered to be "fair and objective". Industry argued that limited compensation would oblige lenders to mutualise their risks, i.e. to divide potential losses among all mortgage borrowers.

4.3. Special circumstances

Notwithstanding the introduction of a possible general legal right, parties discussed whether or not a legal right to early repayment could be granted in any case in "special circumstances".

Consumer representatives supported the idea of a right to early repayment, without compensation, in case of "special circumstances". In their view, no compensation should be payable in those cases where early repayment is made in a period where the rate may be revised at any time; is made at the end of a fixed rate period; is related to the death of the borrower or changes in circumstances of the borrower and is made in one settlement for the total amount outstanding.

In contrast, EBIC insisted that the lender should always be fully compensated, irrespective of the circumstances.

¹ EBIC defined Yield Maintenance Indemnity as being the compensation for the lender's financial damage over the residual fixed interest rate period of the loan.

5. ANNUAL PERCENTAGE RATE OF CHARGE (APRC)

The majority of contributions to the Green Paper concluded that the APRC should be harmonised, both in terms of the method of calculation and of the basis of calculation, in order to facilitate the comparability and transparency of different loan offers.

The "Mortgage Dialogue" was therefore asked to assess the merits of having a specific mortgage APRC (different to the one in consumer credit); to define the method of calculation for the APRC; to determine which costs should be included and which costs should be excluded and to reflect on how the consumer can be made aware of the costs excluded from the APRC.

5.1. Specific mortgage APRC

Both parties were aware of the current discussions on the APRC calculation base, held in the context of the proposal for a new Consumer Credit Directive, and considered that any outcome on this front would have an impact on the discussion on the APRC in the field of mortgage credit.

5.2. Calculation Method

Participants agreed in principle that the same mathematical formula should be applied to calculate APRC for consumer and mortgage credit. However, industry representatives pointed out that in case of combination of products (like the combination of a mortgage loan with a savings or an insurance product) the formula currently discussed in the context of the Consumer Credit Directive might either lead to no solution at all, or to several solutions. Consumer representatives rejected this, arguing that the basic formula is simple enough to allow for all necessary costs to be added, without any mathematical problem in determining the APRC. Consumer representatives pointed to previous studies provided to the Commission on that matter.

5.3. Cost basis for calculation

No compromise was achieved on the question as to which cost elements should be included in the calculation basis for the APRC. Consumer representatives supported a wide cost basis. They argued that, since the APRC is to be used as a tool for both comparison and information, it has to include all costs that the consumer has to pay in connection with the credit, including, for instance, notary costs and taxes. According to consumer representatives, only those costs which are truly optional for the consumer could be excluded. Insurances which are compulsory to obtain a certain interest rate, or "strongly recommended", or concluded at the same time as the loan contract, would have to be included in the calculation of the APRC. This principle is already foreseen, for example, in the Belgian Consumer Credit Law for credits up to EUR 5 000.

Industry favoured a narrow cost basis, claiming that only a narrow APRC would allow for true comparisons. They argued that only those costs levied by the lender for the loan for his own benefit should be taken into account when calculating the APRC.

According to industry representatives, widening the cost-base of the APRC to costs levied by third parties would defeat the object of the APRC (i.e. comparison) because different cost elements would be included in different Member States and consumers would not be in a position to compare like with like. Furthermore, industry representatives commented that most of those transaction costs would not be known by lenders at the pre-contractual stage and, therefore, could not be provided to the consumer. Also, in industry's view, different cost items may be known by individual lenders at that stage: as a result, the basis for calculation of the APRC may end up being "lender-specific", which means not harmonised. This would, according to industry, have a materially adverse impact on the ability of the APRC to become an effective tool for cross-border comparability of mortgage loan offers.