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Study on Mortgage Credit in The European Economic Area Structure of the Sector and Application of the Rules in the Directives 87/102 and 90/88

Final Report on Tender No. XXIV/96/U6/21

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Commission of the European Union, Directorate-General XXIV

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List of Abbreviations and Terms

ABGB	Austrian Civil Code (Allgemeines Bürgerliches Gesetzbuch)
AGBG	German Law on Unfair Terms (Gesetz zur Regelung des Rechts der Allgemeinen Ggeschäftsbedingungen)
APRC	Annual Percentage Rate of Charge
ARM	Adjustable rate mortgage, comprises variable rate mortgages and reviewable rate mortgages.
BdF	Banque de France
bey	Bond-equivalent yield
BGB	German Civil Code (Bürgerliches Gesetzbuch)
BGH	German Federal Court of Justice (Bundesgerichtshof)
BIS	Bank for International Settlements
BoE	Bank of England
BWG	Austrian Banking Activities Act (Bundesgesetz über Bankwesen, Austria)
CCA	Consumer Credit Act (various nations)
CCD	Consumer Credit Directive
CML	Council of Mortgage Lenders (United Kingdom)
CMO	Collateralized Mortgage Obligation
Coupon Rate	Interest rate specified in the debt contract.
EMF	European Mortgage Federation
ERA	Trier Academy of European Law (Europäische Rechtsakademie)
EuZW	European Journal for Economic Law (Europäische Zeitschrift für Wirtschaftsrecht)
FLF	Finanzierung, Leasing, Factoring

FRM	Fixed rate mortgage, includes mortgages with rates fixed over entire term and renegotiable mortgages.
GDP	Gross Domestic Product
GNMA	Ginnie Mae/Government National Mortgage Association
HUD	Secretary of Housing and Urban Development, US
Iprax	Practice of international private and procedural law (Praxis des Internationalen Privat- und Verfahrensrechts)
LTV	Loan-to-value ratio
KWG	Banking Act (Kreditwesengesetz, Germany)
MBA	Mortgage Bankers' Association, US
MBS	Mortgage-Backed Security.
MCD	Mortgage Credit Directive
NJW	Neue Juristische Wochenschrift
OECD	Organization for Economic Co-Operation and Development
par	Nominal value of an asset.
PIR	Price-Income Ratio
RIW	Recht der Internationalen Wirtschaft
VerbrKrG	Consumer Credit Act (Verbraucherkreditgesetz)
VRM	Variable rate mortgage (reference rate)
WCK	Law on Consumer Credit (Wet op het Consumentenkrediet, Netherlands)
ZBB	Zeitschrift für Bankrecht und Bankwirtschaft
ZEuP	Zeitschrift für Europäisches Privatrecht

Introduction

Following the successful bid to tender No. XXIV/96/U6/21, empirica has contracted in February 1997 with the Directorate-General XXIV of the Commission of the European Union to undertake a study on mortgage credit in the European Economic Area: structure of the sector and application of the rules in the Directives 87/102 and 90/88. For the management of this voluminous and difficult task, an interdisciplinary team of legal and economic experts was formed as specified in the bid. It consists of Michael Lea, Cardiff Consulting Services, San Diego; Reinhard Welter, University of Potsdam; and Achim Dübel, empirica, Bonn ("study team").

Shortly after beginning work in early February 1997, an expert survey was launched among consumer and lender groups concerned with the field of consumer lending, especially mortgage lending. The aim of the survey was both to tap supply sources for the necessary legal and empirical material over a wide range of countries, and to raise the interest and engagement of stakeholders in the discussion. The study team would like to express particular gratitude for support in this context: among consumer groups to the Centre de Droit de la Consommation, Louvain La-Neuve; Bureau Europeen des Unions de Consommateurs, Brussels; Test Achat, Brussels; and the European Interregional Institute of Consumer Affairs, Lille; among banking groups to the European Mortgage Federation, the European Banking Association, the European Union of Savings Banks, the Europabüro Bausparkassen and the Association of Cooperative Banks of the European Union, all based in Brussels. Cooperation of numerous national associations as well as individuals and institutions is gratefully acknowledged.

Having said this, the study team wishes to communicate its observation that due to the legal and economic complexity of the issue the information gathering process proved more difficult than expected. A meeting with national banking groups held in Brussels in May 1997 helped clarify key legal points. However, some empirical issues, such as the magnitude of residential mortgage cross-border lending, could not be clarified. To deepen their understanding, the team members undertook extensive travel to Belgium, Germany, Ireland, Italy, France, Spain, Sweden, and the United Kingdom. Other countries were covered by telecommunication.

The study is subdivided into the Summary Report (Part 1), the National Reports on Consumer Protection Regulations (Part 2), and the Annex.

The Summary Report starts in Chapter I with an analysis of the state of transposition of the CCD, giving an overview and discussing the issues to be resolved pars pro toto for the two benchmark cases that formally[1] enacted transposition (Ireland, Germany). The study team emphasizes that a full overview over the complex subject can only be obtained in conjunction with the National Reports that had to be separated as a formal tender requirement[2]. Chapter II surveys the structure and volume of the European markets for mortgage credit, developing a discussion on market shares and dynamics, instrument types and their pricing implications, as well as barriers to entry for cross-border lending. The reader who is not familiar with the individual national mortgage markets is referred to the short national exposes in the Annex, provided by European Mortgage Federation[3]. In Chapter III, legal and economic analysis are merged into a discussion of the relevant issues that arise with a potential transposition of the CCD to mortgage lending, adding other issues relevant for mortgage lending. Models are identified that serve the authors to restrict the empirically observable range of solutions in their strategy recommendations. Chapter IV presents an exposition of the general strategies available for the Commission to pursue its dual targets, securing a minimum consumer protection level in Europe and at the same time enabling cross-border lending. Chapter V includes our summary of findings and recommendations.

The study team hopes that the report presented fulfills the conditions of the tender and sheds sufficient light on the legal and economic feasibility of different options that arise when thinking about European mortgage markets and the possible transposition of the Consumer Credit Directive to mortgage lending. As an interdisciplinary report written under tight budgetary and time constraints it does not pretend to substitute a full-fledged legal and economic comparative analysis of the matter, which would constitute a full research programme requiring higher resource input.

1 By adoption of a law on consumer credit distinguishing between consumer credit in the sense of the CCD and mortgage lending.

2 See section 3 of the specifications of Tender XXIV/96/U6/21

3 Excludes Finland.

PART 1

Summary Report

I. THE STATE OF TRANSPOSITION OF THE CONSUMER CREDIT DIRECTIVE TO MORTGAGE LENDING

The Directive 87/102[4] for the approximation of the laws, regulations and administrative provisions of the Member States concerning consumer credit, based on Art.100 EEC, was adopted by the Council on 22 December 1986. The Directive was amended by Directive 90/88[5] notably with regard to the mathematical formula and the calculation of the APRC. They were intended to set minimum standards of consumer protection in relation to consumer credit in all Member States so as to avoid distortions in competition between providers of credit in the Common Market arising through differences in local law. The differences between the national legislations had led to distortions of competition in the Common market, particularly in border areas[6]. The main goals of the directive are consumer information and transparency of the market. Therefore, consumers must be properly informed with regard to credit terms and costs as well as obligations.

A. Report on the Operation of the Directive 87/102

Pursuant to Art.17, the Commission had to present a report to the Council concerning the operation of this Directive within five years of its entry into effect. The purpose of the report was to verify whether the Directive still corresponded to the objectives for which it was drawn up. One of the main conclusions of the report was that based on Art. 15 of the Directive the Member States went beyond the provisions of the Directive to realize a considerably higher level of consumer protection. Due to this, the Directive has therefore had a modest impact on harmonization.

Another important conclusion was that the Commission should look into the advisability of a new directive on mortgage credit[7] in order to reach a minimum of Community harmonization in regard to mortgage credits with due reference to the principle of subsidiarity[8] and proportionality[9].

The Directive does not apply to credit agreements intended for the purpose of acquiring or retaining property rights in land or buildings or for the purpose of improving or renovating a building (Art.2 I). In several Member States consumer credit law partly or wholly applies to real estate credit earmarked for

4 Council Directive 87/102/EEC of 22 December 1986, OJ No L 42 of 12.2.87, p.48
5 Council Directive 90/88/EEC of 22.February 1990, OJ No L 61 of 10.03.90, p.14
6 Commission of the European Communities (1995), p.11
7 Commission of the European Communities (1995), p. 3l; Reich (1997), Bankrechtstag, p.50
8 The principle of subsidiarity is laid down in Art.3b II EEC
9 The principle of proportinality is laid down in Art.3b III EEC

the said purpose. Some Member States have introduced specific legislation relating to mortgage credits. The report considers it a paradox that Community legislation exists in regard to consumer credit but not in regard to real estate credit. This is based on the statement that purchasing a dwelling is the most important consumer act in relation to consumer's life.

For the purposes of this study the Table I-1 gives a picture how and to what extent as regards mortgage lending the CCD has been transposed[10] in the individual Member states.

Table I-1 State of Transposition of Directive 87/102

	Transposition of the CCD	Transposition to Mortgage Lending	Specific legislation	Code of Conduct
Austria	Consumer Protection Act amended in 1993;	no	Banking Activities Act, §§ 33-35	no
Belgium	Consumer Credit Act (1991)	no	Mortgage Lending Act (1993)	no
Denmark	Credit Agreement Act (1991)	yes, partial (only disclosure)	Mortgage Credit Act	yes (1996)
Finland	Consumer Protection Act amended in 1993	no		no
France	Consumer Protection Code (only minor amendments)	no	Loi Scrivener II, incorporated in the Consumer Protection Code	no
Germany	Consumer Credit Act (1990)	yes, partial	no	no
Greece	Ministerial Decision (1991)	no	no	no
Ireland	Consumer Credit Act (1995)	yes, part IX	no	no
Italy	Act No 142, incorporated in Testo Unico (1994)	no	Art.40 et sequ. and 115 et sequ. of the Testo Unico	yes*
Luxembourg	Law of 09/08/1993	no	no	no
The Netherlands	Law on Consumer Credit (1989)	no	Self-regulation-system	yes (1990)
Norway	Sale of Goods on Credit Act no 82; Act on Financing Activity and Financial Institutions no.40	no	Secondary regulatiuons	no
Portugal	Decree-law no.359/91	no	no	no
Spain	Consumer Credit Act (1995)	no	Law 271994 concerning subrogation and modification of mortgage loans	no
Sweden	Consumer Credit Act amended in 1993	no	Since 1979 the Act covers all types of consumer credit	no

10 This limits the overview to legislation following the enactment of the CCD. In this context previous legislation on mortgage lending is not taken into account as it is not based on a transposition of the CCD. The National Reports (Part 2) will give full coverage.

United Kingdom	Consumer Credit Act (1974) only minor amendments	no	Regulated loans up to £15,000 are governed by the CCA	yes (1997)

Note: *Codice di Comportamento del sezzore bancario e Finanziario. For details see National Reports.

B. Analysis of the Consumer Credit Directive with Respect to Mortgage Lending

As a first step the study team would like to give a short analysis of the different articles of the Directive 87/102 in order to get a clear picture as to whether it is feasible in principle to transpose the Directive to mortgage lending following the wording of the provisions.

In this respect it is particularily useful to look at the examples where the CCD has been transposed by extending it to mortgage lending. As Table I-1 shows, no Member state has transposed the Directive in the sense of extending it completely to mortgage lending. In only three cases partial transposition to mortgage lending has taken place. In the case of Denmark this partial transposition has been very limited (some aspects of disclosure). Only in Germany and Ireland all provisions of the CCD had been under consideration in the legislative process whether to be adopted for regulation on mortgage lending. As this unique benchmark situation only applies to these countries they will particularily be referred to as examples for the feasibility of a transposition.

The study team wishes to emphasize that this does not mean that the legislation in these two countries is of particular weight as compared to other sample countries. Empirically, the German experience deserves special attention as the relevant legislation was introduced in 1991 and has been applied for several years. On these grounds it should be appropriate to presume that the preliminary view may roughly determine the scope of the intended study and show whether a transposition appears feasible. National reports and an analysis of the relevant issues follow below.

1. Article 1: Definitions

The first article contains important legal definitions.

a) Consumer

(1) Content

The *consumer* is defined as a "natural person who, in transactions covered by the directive is acting for purposes which can be regarded as outside his trade or profession".

The directive follows the common European definition used in directives aimed at consumer protection (e.g., Art.2b of the Directive on Unfair Terms in Consumer Contracts[11]) and other legal texts based on the Treaty, e.g., Art.13 of the Brussels Convention of 27.September 1968 on jurisdiction and the enforcement of judgments in civil and commercial matters[12] and Art.5 of the Rome Convention of 19.June 1980 on the law applicable to contractual obligations[13].

(2) Transposition

Various solutions have been adopted: certain Member States have transposed the definition verbatim[14], whereas others have extended the circle of beneficiaries. The German definition in § 1 I VerbrKrG[15] is much wider in scope than the Directive as it includes persons entering into a credit agreement with a view to starting a business. However, the question of extending the directive's scope is not specifically related to mortgage lending, but a general one. Therefore, in the interest of a uniform approach even at first glance it seems quite appropriate to follow the general definition in this context as well. On the other hand, however, the distinction between consumer transaction and others becomes more difficult with respect to mortgage lending as this may involve major investments in immovables other than personal dwelling which lie beyond the scope of typical consumer protection. In order to distinguish consumer contracts and larger investment contracts exemptions (see below) or a precision of the term „trade" would be appropriate.

11 Council Directive 93/13/EEC of April 5, 1993 on Unfair Terms in Consumer Contracts, O.J. 1993, L95/29

12 OJ No C 189, 28.7.90, p.2

13 Convention on the law applicable to contractual obligations, 80/934/EEC, OJ No L 266, 9.10.1980, p.1

14 Ireland: Part I section 2 of CCA: „Consumer means a natural person acting outside his trade, business or profession."

15 German Consumer Credit Act 17.12.1990, entered into force the 1.1.1991, BGBl I s.2840

b) Creditor

(1) Content

The *creditor* is defined as a natural or legal person who grants credit in the course of his trade, business or profession, or a group of such persons.

(2) Transposition

In most Member States the legal definition of the creditor is identical with the European definition given in the Directive. The German and the Irish legislatures have adopted the definition in § 1 I VerbrKrG and Part I section 2 CCA. A transposition to mortgage lending appears feasible.

c) Credit agreement

(1) Content

The *credit agreement* is defined as an agreement whereby a creditor grants or promises to grant to a consumer a credit in the form of a deferred payment, a loan, or other similar financial accommodation.

(2) Transposition

The objective of the Directive was to cover all forms of consumer credit, no matter how defined. The Irish legislation has adopted the definition in Part I section 2 of the CCA verbatim, whereas German legislation has nearly adopted the definition. As regards mortgage lending the question may be raised whether a regulation could be limited to loans (as opposed to deferred payment and other facilities). The study will look at the various products existing in the Member states in order to decide whether other financial accommodations come into play. As far as deferred payment is concerned it is evident that this is not the typical instrument for mortgage lending. In the case of professional sellers (cf. the definition of lender), however, it may still be advisable to extend the scope to deferred payments. These types of contracts are almost always between the buyer and the seller (of the house).

2. Article 1 a: APRC

a) Content

The Directive 90/88, adopted on 22 February 1990, introduced article 1 a into the CCD. In this article we find a Community method of calculating the "annual percentage rate of charge" for consumer credit and a definition of the credit cost items to be used in the calculation by indicating those costs which were not to be taken into account. In order to assist in the functioning of the single market and also to ensure that consumers benefit from a high level of protection, it was felt that one method of calculating the APRC should be used throughout the Community[16].

b) Transposition

Besides details regarding the calculation of APRC the principal question arises whether APRC can be an appropriate means to compare the various financing products in this field. This discussion on the European level already has a considerable history[17]. This issue will therefore be treated in detail in this study (Chapter III).

3. Article 2: Exemptions

a) Content

The article defines consumer credit rather than mortgage lending, e.g., intended primarily for the purpose of requiring or retaining property rights in land or intended for the purpose of renovating or improving a building as such. The directive does not apply to credit agreements involving amounts more than 20.000 ECU and a number of articles shall not apply to credit agreements secured by mortgage on immovable property.

Certain financial accommodations are exempted, e.g., hiring agreements except where these provide that the title will pass ultimately to the hirer, credits in the form of advances of a current account granted by a credit institution or financial institution other than credit card accounts and certain short term credit agreements.

16 Maitland-Walker, EC-Banking Directives, 4.62

17 See for more details Vorms (1993); Memorandum on the report by Mr.Vorms, European Mortgage Federation (1993).

b) Transposition

A mortgage lending directive will have to define mortgage lending in a corresponding sense. As regards the exempted financial accommodations the question will be raised whether they are relevant in mortgage lending and should also be exempted. For this purpose the study team will look at the various products in this field.

The scope of a directive will be determined by whether a ceiling as regards the loan amount will apply. It is evident that mortgage lending to consumers comprehends small amounts, e.g., for renovation, and larger sums for the acquisition of urban dwelling as well. However, if a certain level is exceeded it may seem doubtful whether a typical consumer transaction takes place rather than a major investment not requiring consumer protection. This may particularly be the case if a consumer finances a large number of rental units.[18]

Part IX of the Irish CCA is explicitly applicable to housing loans made by mortgage lenders. The definition given in Part I section 2 for housing loans is the following: "housing loans means an agreement for credit on the security of a mortgage of a freehold or leasehold estate or interest in a house where

a) the loan is made for the purpose of enabling the borrower to provide or improve the house or to purchase the said estate or inerest, or

b) the loan is made for the purpose of refinancing a loan within the meaning of para (a), or

c) the house is to be used or to continue to be used as the principal residence of the borrower or his dependants."

The German example shows that the distinction between consumer credit and mortgage lending may cause substantial problems. § 3 II Nr.2 VerbrKrG refers to credit where the lender enters into the agreement under the condition that the borrower gives security by way of mortgage on land and where the terms of the loan correspond to conditions which are common to mortgage lending. This complicated definition tries to be applicable with respect to the loan agreement even when mortgages have not yet been made. On the other hand it tries to avoid the risk that lenders require a mortgage in order to avoid the stricter rules applying to consumer credit.

18 If a ceiling appears inappropriate, one could consider to amend the consumer definition in Article 1 by a specification of the term „trade", excluding loans designed to finance investments on a larger scale.

4. Article 3: Advertisement

a) Content

Article 3 provides that the annual percentage rate of charge must be included, by means of a representative example, if no other means is practicable, in any advertisement in which a rate of interest or any figures relating to the cost of the credit are indicated.

b) Transposition

It is evident that a transposition depends on the outcome of the discussion whether APRC is a recommendable indicator of the costs of the credit. If this is the case it should be included in any advertisement described in Art. 3 of the CCD.

5. Article 4: Form and Disclosure

a) Content

Article 4 provides that the written agreement must include a statement of the APR and a statement of the conditions under which the APR may be adjusted. Furthermore, the Directive's annex contains a list of contractual terms which are required to be included in the written agreement. Beyond that the Directive does not stipulate any further standardization of consumer credit agreements.

b) Transposition

Disclosure is a major issue in the field of consumer protection related to mortgage lending. The Consumer Credit Act in Germany contains an obligation that the credit agreement must be in writing in § 4 I 1-3 VerbrKrG. The written contract must include some essential information. The offer must contain the different elements of cost incurred as a result of the credit (Kreditnebenkosten) and must specify the conditions under which the contract is adjustable. Sections 128 to 135 of the Irish CCA cover disclosure of information in detail. In addition to the obligation to disclose information the law provides for warning duties.

It is evident that a simple transposition of Article 4 concerning disclosure requirements is not recommendable. The requirements are designed for consumer contracts. The specific features of mortgage lending credit and its larger complexity must be taken into account[19]. On the other hand, however, the larger complexity should not lead to overburdening the underwriting situation. Another question to be raised is whether a standardization of mortgage contracts is advisable to improve comparability.

6. Article 5: Total Cost of the Credit

Article 5 is no longer in force as it has been repealed by the Directive 90/88. This article provided that the creditor had to indicate the total costs of the consumer credit contract. Even at first glance a transposition of this article to mortgage lending would have been highly questionable. Indicating the total cost does not give a sound basis to compare different offers; at any rate requiring the APRC is more efficient in that respect (see above). Neither may the indication of the total costs really help the consumer to make the right decision on his investment.

In this respect the German example may be particularly helpful. Originally, the provision has applied to mortgage lending, causing substantial controversy. Finally, the German legislature in May, 1993 has repealed the obligation to disclose the total amount of cost as this indication was seen to be misleading and far from reality[20].

7. Article 6: Overdrafts

Article 6 of the Directive applies to overdrafts. Whether this special kind of personal credit in the form of advances on current account is relevant in mortgage lending will be shown by the survey of the various products.

8. Article 7: Repossession of Goods

a) Content

Member States are to lay down the conditions under which goods obtained by credit may be repossessed using compulsory or voluntary procedures. They must ensure that, in these cases,

19 Reich (1997), Bankrechtstag, p.52

repossessions do not entail unjust enrichment. To this end, account should be taken of the amount repaid, the depreciation of the value of the goods and the value obtained by the consumer during his period of possession.

b) Transposition

The provision is mainly aiming at the seller's rights under the sales contract, e.g., based on a reservation of title clause. Consumers were seen under great risk to lose the good acquired and incurring interests and other costs from the deferred payment or the loan given by a third party. This situation is not relevant as far as immovables and mortgage lending is concerned.

In a larger sense this article could give reason for opening a discussion on repossession in the context of the enforcement of mortgages. As opposed, however, to the sales situation in Art. 7 of the directive the national laws on mortgages have always been aimed at protecting the mortgagor's interest and to exclude unfair treatment by the mortgagee and his unjust enrichment. Any directive interfering with the law on mortgages would presume that the legal situation in that respect is not satisfactory. In addition, procedural rules of the individual Member States come into play and even constitutional aspects can be touched upon (protection from losing property under unfair conditions). This explains why the commission has explicitly taken the position that a directive on mortgage lending should in no way interfere with the national law of mortgages.[21] This view is confirmed by Art. 13 of the German VerbrKrG transposing Art. 7 of the directive and being limited to consumer credit in a narrow sense. The study team will therefore not discuss Art. 7 of the directive any further.

9. Article 8: Early Repayment

a) Content

Where a time for repayment has been fixed in the contract the Directive gives the consumer the right to discharge his obligation before that date. The consumer is further entitled to an equitable reduction in the total cost of the credit. It is left to the Member States to decide the amount by which the total charge for the credit is to be reduced in those circumstances.

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20 BR-Drs 12/4526, 17, see Habersack (1994), p.361-366 (362)

21 Cf. The commission's statement on the intermediary report of the study team delivered in April 1997.

b) Transposition

Early repayment seems to be the most important issue in the field of consumer protection related to mortgage lending. In its first assessment the study team presumes that any regulation should consider differences in refinancing methods. At any rate, a solution should be more sophisticated than that provided in the CCD.

This view is supported by the German and the Irish examples. In the event of early repayment by the consumer, the German Consumer Credit Act contains detailed provisions in § 14 VerbrKrG on how to calculate the rebate in the cost of the credit. These provisions, however, are only applicable to deferred payment in sales contracts. Early repayment in loan contracts of any kind is not treated in this context. We find a much more sophisticated solution in § 609 a of the Civil Code distinguishing between ARM and FRM. The same is true for the Irish law which even goes into detail as defining loans with capped adjustable rates as FRM (section 121-2).

10. Article 9: Assignment

a) Content

The consumer is guaranteed that if creditor's rights are assigned to a third person, the consumer will be entitled to plead against that person any defenses which were available to him against the original creditor.

b) Transposition

The protection of borrowers in Art. 9 of the CCD, which has been directly transposed into section 40 of the Irish CCA applying to mortgage lending as well, seems to be indispensable as assignments should by no means impair the borrower's position. This is confirmed by the German § 10 I VerbrKrG providing that a derogation from the general rules of the Civil Code providing this protection is null and void. This rule has been transposed without any exemptions to mortgage lending. As far as the study team can see, this legislation has not affected the rules governing the transferability of mortgages under the principle of good faith in the land registry (§ 1138 BGB)[22]. This should also be true for any European legislation as it is the explicit position of the Commission not to interfere with mortgage law (see above).

22 Baur/Stürner (1994), 38 IV; as to non accessory mortgages (Grundschulden) see § 44 V

11. Article 10: Bills of Exchange:

a) Content

It is left to the Member States to ensure that the consumer is suitably protected when using bills of exchange, promissory notes, or cheques.

b) Transposition

Art. 10 has been transposed to mortgage lending under German law (§ 10 II VerbrKrG). This has not had any effect on the practice of mortgage lending as bills of exchange, promissory notes or checks are not used in financing techniques. The study team will have to find out whether this is also true in the other Member States. Particular attention deserves the "ipoteca cambiaria" according to Art. 2831, 2845 of the Italian Civil Code.

12. Article 11: Linked contracts

a) Content

Article 11 establishes a link between the credit agreement and the sales agreement. It provides that the consumer is entitled to pursue remedies against the creditor if there is a legal bond between the creditor and the supplier of goods and if the supplier of goods defaults on his obligation under specific conditions.

b) Transposition

Art. 11 takes into account the risks created by splitting up a contract of sale with deferred payment into two separate contracts (sale on one hand and loan on the other). Very often, the consumer is not fully aware that remedies can be excluded on account of this situation.

As regards mortgage lending the point of departure is different. Financing the sale of real estate has always been a separate transaction carried out mainly by banks. The study team will look at the rules existing in the Member States and at respective complaints to get a complete picture in this respect.

In the German example consumer credit and mortgage lending are clearly separate. German legislation has transposed Art.11 of the Directive into § 9 of the Consumer Credit Act. Under § 3 II Nr.2 VerbrKrG, however, the rule concerning linked contracts, § 9 VerbrKrG, is explicitly not applicable to mortgage lending. The German legislature has found per se that these rules are not suitable for mortgage lending[23]. This is based on the understanding that there is in general no link between the mortgage credit agreement and the sales contract[24]. Exceptions, however, are discussed with respect to cases where banks, untypically, are in the role of the seller or particularly close to him[25].

13. Article 12: Implementation/Sanctions:

a) Content

Art.12 (1) of the Directive gives Member States three options for supervision of the implementation of the Directive:

a) a requirement that persons offering credit or offering to arrange credit agreements shall obtain official authorization; or

b) a requirement that persons granting credit or arranging for credit to be granted shall be subject to inspection or monitoring by an official body[26]; or

c) the promotion of the establishment of bodies to receive complaints concerning credit agreements or conditions and to provide information to consumers in this regard.

Art.12 II provides that the authorization referred to in a) is not necessary where such persons satisfy the definition given in the First Banking Directive[27]. Under the terms of this Directive and the later Second Banking Directive[28], therefore, financial institutions, need only obtain a single authorization.

Art.12 requires admission for persons granting credits or on credit intermediaries.

b) Transposition

A transposition of this article to mortgage lending seems to be possible.

Article 12 of the Directive has been transposed into the German "Kreditwesengesetz" (KWG).

23 Pfeiffer (1996), ZBB, p. 304 -321 (305)

24 Heymann (1995), p.175; Früh (1995), Die Bank, p.426-429(426); Pfeiffer (1996), ZBB, p.304-321 (305)

25 See Habersack (1992), ZHR, p.45-62; Pfeiffer (1996), ZBB, p.304-321

26 Article 12 (2) provides that the authorisation referred to in option (a) is not necessary where such persons satisfy the definition given in the First banking Directive, Council Directive of 12 /12/77, OJ No L 322 17/12/77

27 Council Directive 73/183/EEC of July 16, 1973, First Banking Directive, OJ L194/1

28 Council Directive 89/646/EEC on the co-ordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC of December 15, 1989, OJ No L 386/1, 30.12.1989

14. Article 14: Mandatory nature

a) Content

Article 14 stipulates that the Directive's provisions are mandatory. The ban on circumvention is a general one, and the example provided in the Directive itself, i.e. the device of distributing the amount of credit over several agreements, is not exhaustive.

b) Transposition

A transposition is possible.

The German law provides that all contravening provisions are null and void if they limit the consumer rights of the Consumer Credit Act (§ 18 VerbrKrG).

15. Article 15: Minimum Harmonization

a) Content

Article 15 provides that the Directive shall not preclude Member States from retaining or adopting more stringent provisions to protect consumers consistent with their obligations under the Treaty, which represents the principle of minimum harmonization. This technique is typical for consumer protection on the European level[29].

It is evident that this principle can also be applied to mortgage lending. On the other hand it should be considered carefully to what extent such a directive may substantially change the existing situation with respect to consumer protection and non existing or distorted competition. It must be noted that the report on the operation of the Directive 87/102/EEC presented by the Commission emphasizes rather critically that the Member States in general have gone beyond the provision of the Directive so that the importance of the Directive has been reduced to a catalytic effect[30]. This question will therefore be discussed in detail later.

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29 Reich (1996), p.303

30 Commission of the European Communities (1995), p.14

C. Issues Beyond the Scope of the Consumer Credit Directive

In its bid to the tender the study team has already indicated some issues not dealt with by the Consumer Credit Directive. In the course of the research this list has been completed and will now be presented in order to determine what shall be covered in the national reports presented in the annex and Chapter III.

1. Counseling Duties

Beyond the duties regarding information and disclosure which were discussed under Article 4 of the CCD so-called counseling duties of lenders may be discussed. They go farther in the sense that they do not concern the product offered by the lender but refer to circumstances and events on the side of the borrower, e. g., in the case of a house purchase the appropriateness of the price or the appropriateness of the choice of the loan product under the prevailing circumstances including such questions as taxes, etc. Under counseling duties one may also include the lender's obligation to explain closed contract conditions when the borrower obviously is unable to understand their meaning and impact.

2. Borrower's Options

a) Loan Offer Procedure

Starting from the fact that a borrower in the case of mortgage lending takes a far-reaching and important decision, the question arises whether the loan contract should be concluded according to the general rules. Special regulation could provide for a deliberation period for the consumer which would also give him the opportunity to compare various offers. It is evident that the problem on the side of the lender is whether and for what time period he must hold contract conditions constant.

b) Cooling-Off Period/Rescession/Revocation

The aim of protecting of the consumer from taking precipitate decisions may also be achieved by the mechanism of a cooling-off period. In this case the borrower is protected in the sense that he has already signed a contract which he can make invalid during a certain time period. The problems on the side of the lender are comparable to what has been said with respect to the loan offer procedure (see above).

c) Rescission in the Case that the Underlying Real Estate Acquisition of Other Financing Contract does not Materialize

More specific would be a protection offered to the borrower which only applies when his expectations regarding the purpose of the financing transactions are not met. This may particularly be the case when a financing transaction is supposed to finance the acquisition of real estate and when the acquisition fails. In this case the lender would not be exposed to the borrower's discretion as regards the finality of the contract. He would still have to carry the burden of events outside of his control and knowledge.

d) Portability

Portability may be defined as the borrower's right to change the underlying collateral while maintaining the contract. This right may become relevant when the borrower decides to sell the house or other dwelling mortgaged to secure the loan. If in this context he acquires other corresponding or higher quality property the question arises whether the lender will have to accept a transfer of the mortgage leaving the loan conditions unchanged.

e) Assumability

Assumability is the right of the mortgagor to transfer the mortgage in the case of a sale of the house to the purchaser. With respect to portability this option is of interest to the borrower if the loan is profitable as compared to the prevailing conditions at the time of the transaction. In this case a purchaser is interested in assuming the loan and paying a corresponding price to the seller.

f) Rescheduling and Discharge as a Remedy against Overindebtedness

The question of overindebtedness in relation to consumer credit is an especially controversial issue. It is evident that in the case of mortgage lending larger sums are involved but the collateral typically covers at least a large part of the outstanding debt. Beyond that, however, the question arises whether the borrower should be protected from losing the collateral through closure procedures by rescheduling his debt.

3. Lender's Options

a) Adjustment of Rates

An important difference between mortgage lending and consumer credit may be seen in the fact that Fixed Rate Mortgages (FRM) and Adjustable Rate Mortgages (ARM) can be distinguished. As regards the unilateral adjustment of rates by the lender the question arises to what extent the adjustment must be determined by the contract itself and to what extent it can be left to the lender's discretion. It is evident that the borrower's position is substantially improved if precise criteria are required for the loan contract, leaving little or no room for the lender's decision.

b) Creditor's Rights in the Case of Default

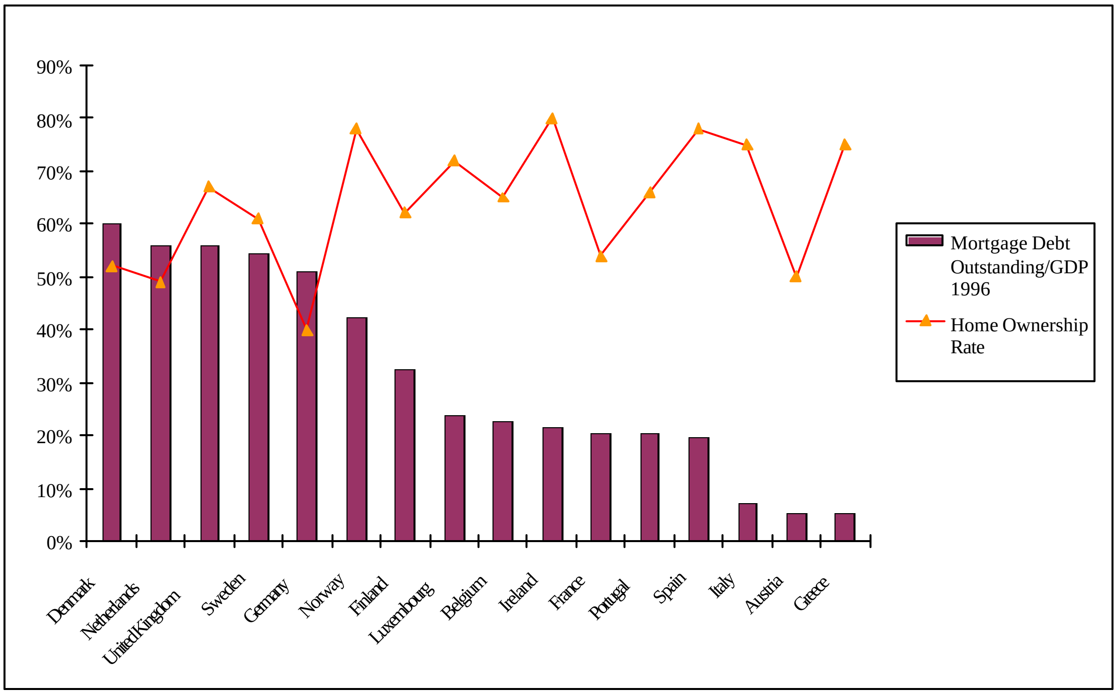
Another main issue not covered by the CCD concerns the creditor's right in the case of default. This involves on one hand the lender's right to resolve the contract and to claim all outstanding sums. On the other hand, focus is on the lender's right to claim compensation for payments becoming overdue either in the course of the contract or after its resolution. In addition, the question arises as to what extent the borrower must compensate the lender for the loss resulting from the loan becoming due prematurely. It is evident that these issues are linked to the problem of borrowers becoming overindebted in the case of default.

II. STRUCTURE OF EUROPEAN MORTGAGE MARKETS

A. Market Size and Trends

The mortgage market is the largest consumer debt market in Europe. As of 1991, outstanding mortgage debt in the 12 largest EU countries was over 4 times larger than outstanding consumer debt.[31] Unfortunately as there are no comprehensive data on European consumer lending a more detailed comparison is impossible.

Figure II-1: Mortgage Debt and Homeownership

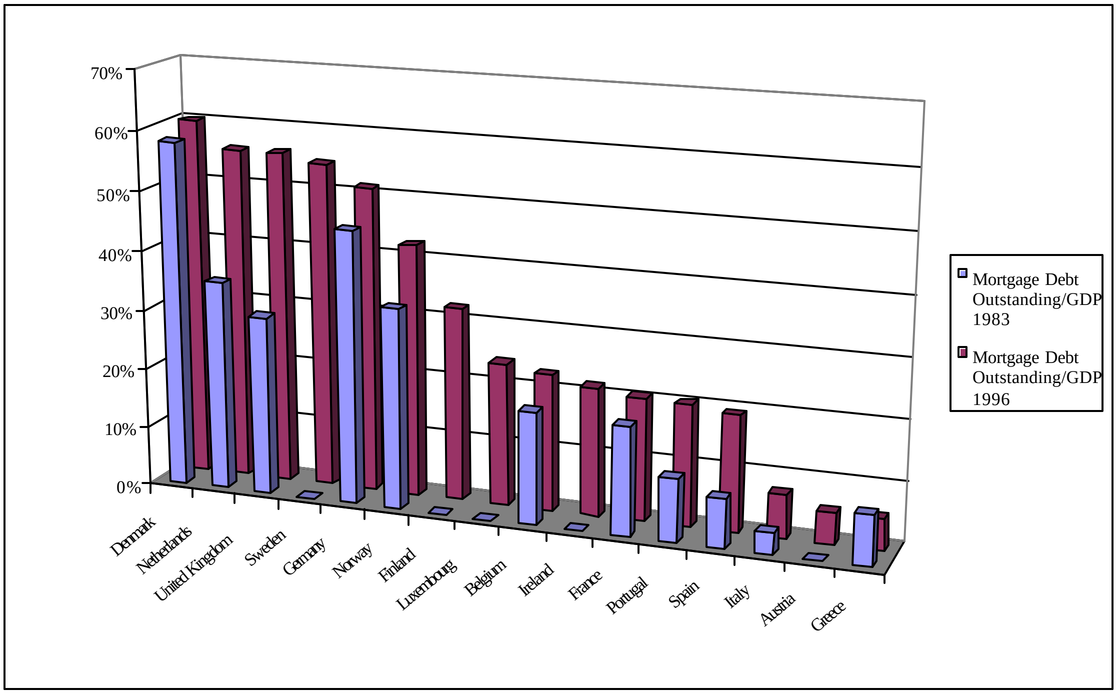


Source: European Mortgage Federation (1996). Note: Outstanding debt is understated for Austria, Denmark and Italy as it is for EMF members only.

There are significant differences among member states in the size of their mortgage markets. Figure II-1 shows the ratio of mortgage debt outstanding-to-GDP and homeownership rates, by country, in the EU at the end of 1996. The size of the mortgage market relative to the national economy varies enormously. Denmark, Germany, the Netherlands, Sweden and the UK all have mortgage debt-to-GDP ratios in excess of 50% whereas Greece and Italy have ratios of less than 10%.

As shown, most EU countries have experienced a growth in mortgage debt outstanding relative to GDP since 1983. Growth has been particularly pronounced in the Netherlands, UK, Spain and Portugal. For countries for which data are available only Greece has shown a decline in the importance of mortgage debt in the national economy.

Figure II-2: Growth in Mortgage Debt-to-GDP

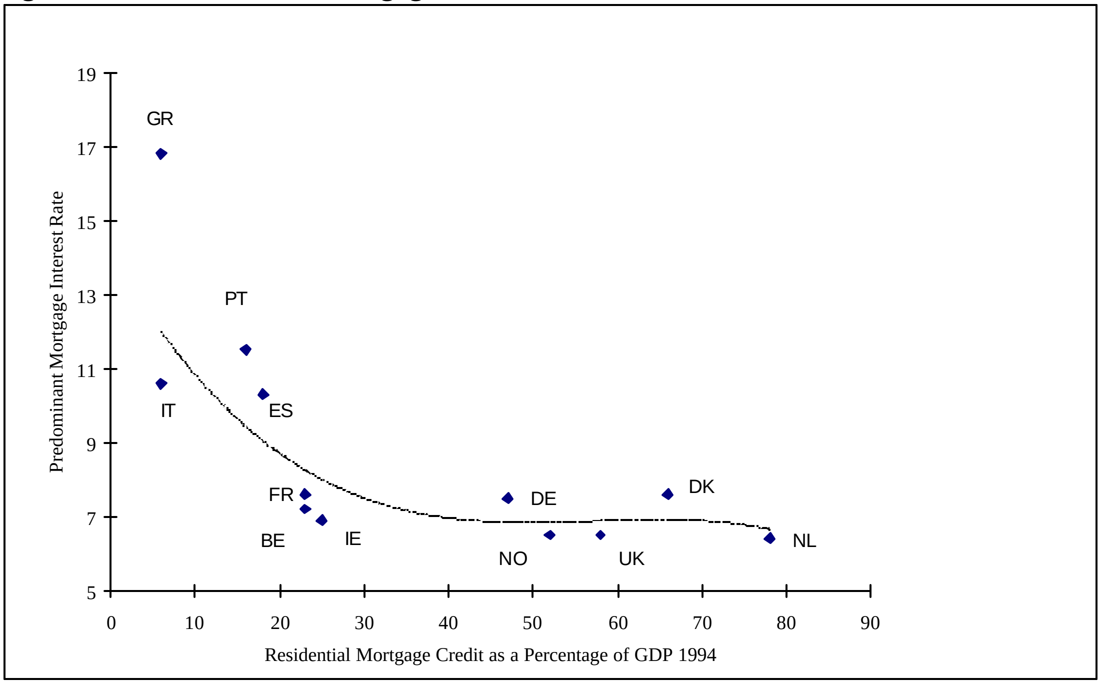


Source: European Mortgage Federation, US Secretary of Housing and Urban Development.

Why are there such differences in the degree of mortgage indebtedness? The relative size of the market is not related to homeownership rates as those countries with the highest rates of homeownership have some of the lowest ratios of mortgage debt-to-GDP. Factors such as the degree of urbanization, relative user costs of rental versus owner-occupied housing, and level of interest rates all affect the use of mortgage credit. The relative efficiency of the mortgage market, as reflected in the underwriting and pricing of mortgage loans as well as the degree of consumer protection will also have an effect. Countries with legal systems that make foreclosure and repossession more problematic, such as France, Italy, and Spain, have lower ratios of mortgage debt outstanding-to-GDP than those countries in which lenders have better access to collateral. Also, the significant use of interest-only endowment mortgage in the Netherlands and the United Kingdom may help to explain their relatively high mortgage debt-to- GDP ratios. However, a more in-depth analysis is needed to separately estimate the effect of these components.

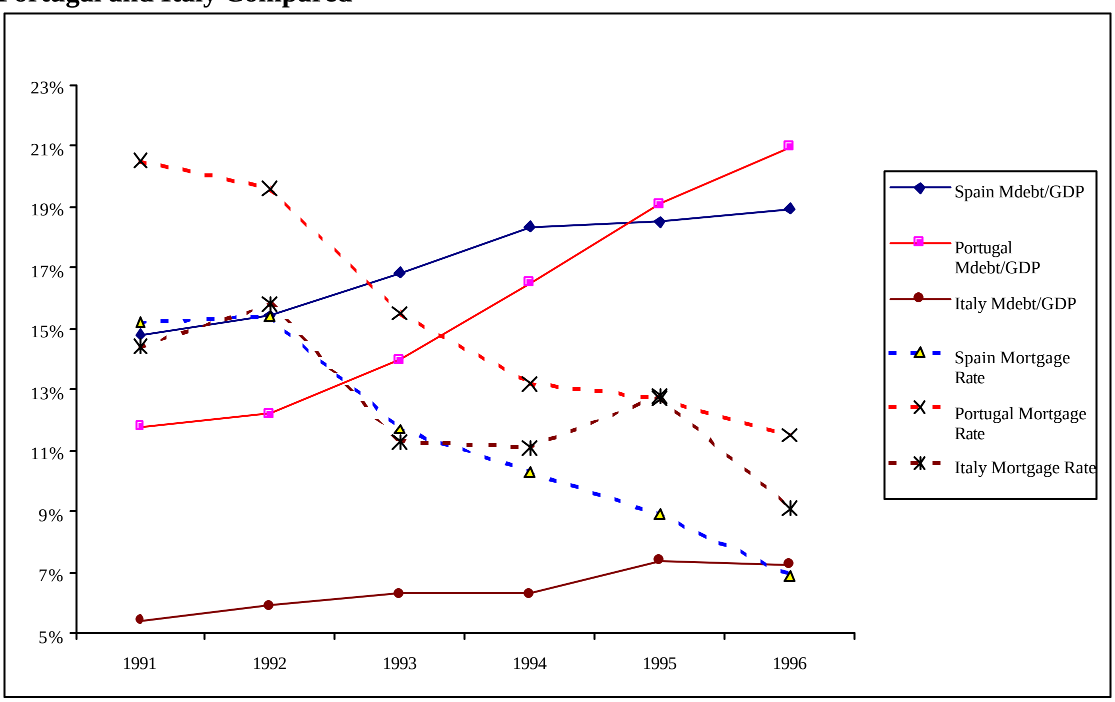
31 Assessment based on the Report on the Consumer Credit Directive and EMF data.

Figure II-3: Predominant Mortgage Interest Rate and Market Penetration, 1994



Source: European Mortgage Federation (1995).

Figure II-4: Changes in Mortgage Interest Rates and Mortgage Market Dynamics – Spain, Portugal and Italy Compared



Source: European Mortgage Federation, International Monetary Fund.

Figure II-3 shows the relation between market penetration of mortgage credit in Europe, expressed as residential mortgage credit per GDP in 1996, and the typical mortgage interest rate. Typically, the higher the nominal rate of interest, the less affordable is mortgage credit.[32] The relationship was even more pronounced in the early 1990s, before the EMU convergence process led to narrowing interest rate differentials; however, market penetration is slow to adjust to new financial conditons.

The effect of a reduced cost of credit on market penetration and dynamics can be graphically illustrated for the case of Italy, Spain and Portugal, three countries that have seen the greatest reduction in rates with EMU rate convergence. In all cases, rates have declined sharply (dashed lines) and – in combination with conducive economic policies - induced a strong dynamic of mortgage lending. This holds particularly for Portugal and Spain, which have in general lower legal barriers to mortgage lending.

Mortgage affordability as well as the terms and conditions of mortgage credit affect the degree of mortgage indebtedness in a country. As shown in Table II-1 there are significant differences in the affordability of owner-occupied housing, as measured by the house price-to-income (PIR) ratio. The ratio is very high in Germany, which contributes to a relatively low homeownership rate yet high ratio of mortgage debt outstanding-to-GDP. The PIR is also high in Spain and Portugal, countries with relatively low ratios of mortgage indebtedness. Holding other factors constant, underwriting terms will affect the use of debt. Countries with lower typical LTVs and shorter terms will exhibit lower levels of indebtedness (France, Italy). Mortgage characteristics also matter. Both Netherlands and the UK make extensive use of endowment (non-amortizing) mortgages which contribute to a high mortgage penetration.

32 With standard mortgage instruments (FRM, ARM), inflation creates the so-called „tilt“ effect: the higher the nominal interest rate, the more are real repayments pulled forward to the early years of the loan. This drives debt service ratios up and creates substantial affordability problems. Alternatives (eg. indexation) are available, but were historically not widely used in European high-inflation economies.

Table II-1: Typical Borrower Profiles around 1994, Selected Countries

Country	Household Revenue	Loan Value	Purchase Value	LTV	Price-Income-Ratio
	ECU	ECU	ECU		
Belgium	57,960	86,699	142,798	61%	2.5
Denmark	45,802	80,062	100,077	80%	2.2
Germany	31,445	157,224	226,927	69%	7.2
Spain	13,800	51,624	64,350	80%	4.7
France	31,489	48,960	79,993	61%	2.5
Italy	44,736	50,271	134,208	37%	3.0
Netherlands	31,028	77,570	107,799	72%	3.5
Portugal	12,726	67,288	84,110	80%	6.6
United Kingdom	28,139	60,026	82,227	73%	2.9

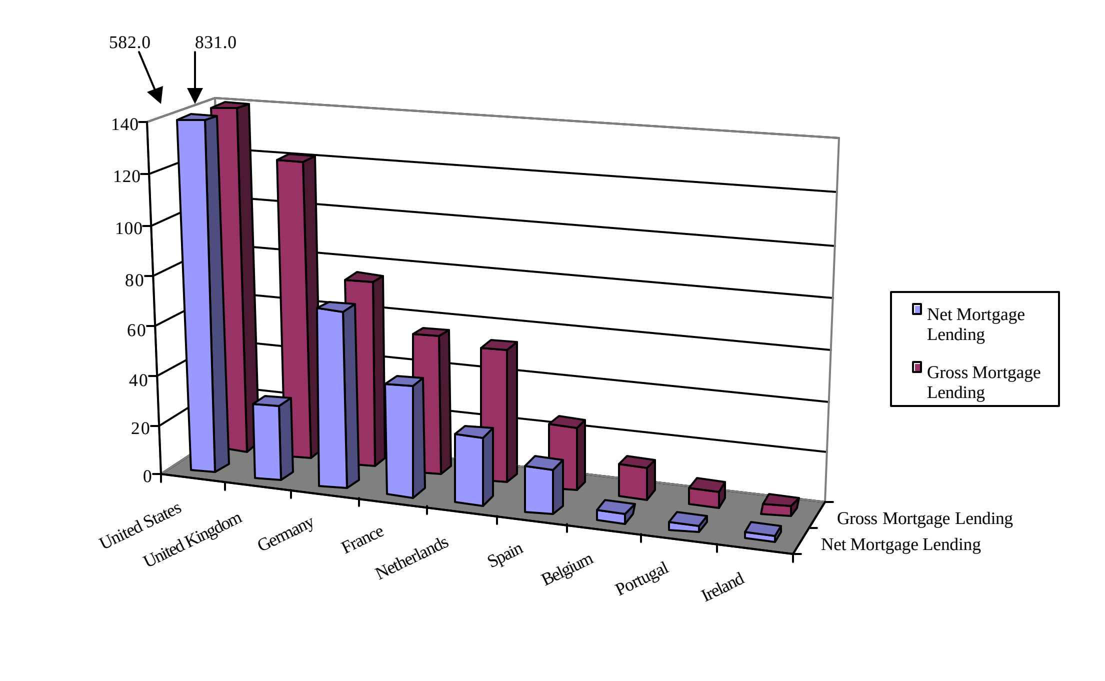
Source: EMF (1997). Note: Germany loan value data reflect special data source (mortgage banks). Other sources indicate av. loan sizes of approx. 130,000 ECU. Denmark revenue data for dual income households.

Another dimension of mortgage markets is the degree of turnover in the stock of outstanding debt. Turnover takes place when debt is repaid in the case of a household move or mortgage refinance. Figure II-5 shows gross and net mortgage originations in EU countries. Net lending is substantially less than gross lending in Belgium, Denmark, Netherlands, Spain and the UK. In large part this difference reflects a relatively high incidence of mortgage prepayments sparked by recent declines in interest rates (Figure II-6).

Mortgage products will affect both the amount of debt outstanding and the difference between gross and net lending. The use of ARM mortgages would generally lead to lower rates of prepayment and a compression in the difference in gross and net mortgage lending. ARMs are the predominant mortgage product type in Spain and the United Kingdom, two countries with high prepayment rates in recent years. In the case of the U.K., the combination of a rate war among buildin g societies including cash back incentives to refinance along with increased use of fixed starting rate periods explains the difference between gross and net lending. In the case of Spain, new legislation capping the penalties for early repayment in a sharply decreasing interest rate environment have been associated with unusually high rates of prepayment.

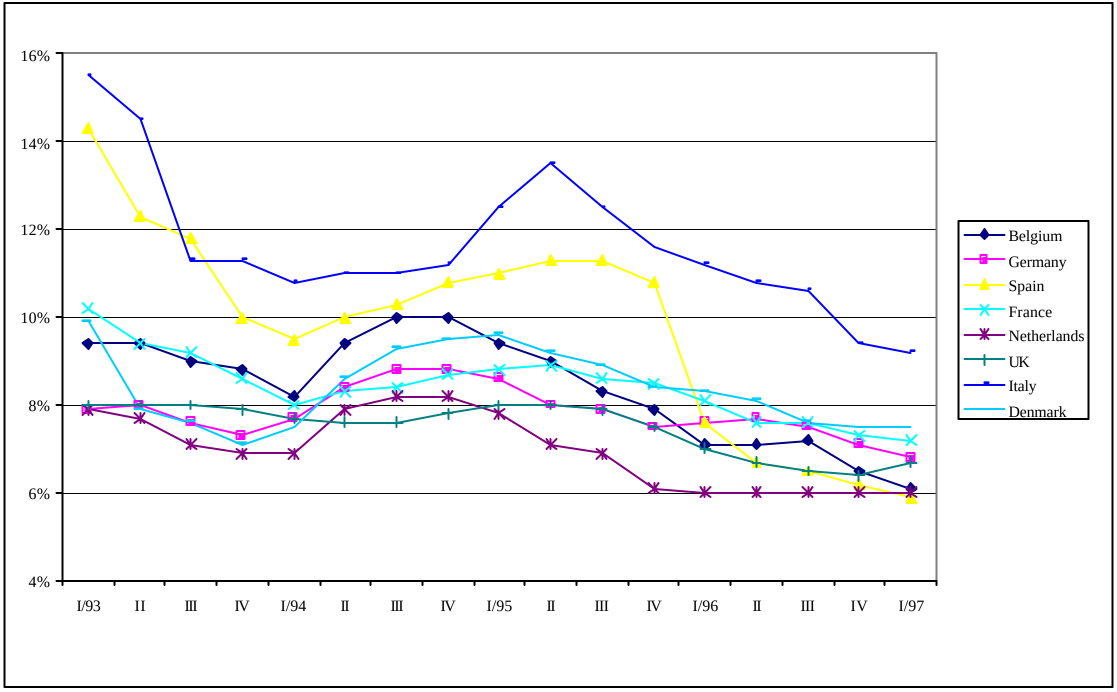
The decline and convergence in mortgage interest rates reflects the increasing influence of Maastrict on national macroeconomic policy. This trend, along with the elimination of exchange rate risk will remove major barriers to cross-border lending and savings competition. EMU will also impose additional costs on banks and squeeze net interest margins which will reduce the internal cross-subsidization whic h has been a common feature of depository-based mortgage lending (discussed below). This in turn may lead to more capital market funding of housing, particularly through the greater use of securitization as a funding vehicle.

Figure II-5: Gross and Net Mortgage Lending 1996 in Million ECU, Selected Countries



Source: European Mortgage Federation, national sources. Note: Net mortgage lending = change in outstanding mortgage loans. Gross mortgage lending = new disbursements.

Figure II-6: Trends in Mortgage Interest Rates, Selected Countries



Source: European Mortgage Federation.

The decline of rates in expectation of the Single Currency may have stimulated greater use of ARMs, but a generally lower and more stable interest rate environment may induce more borrowing in general and greater use of fixed rate mortgages. As noted by the Governor of the Bank of England, the predominance of the variable rate rate mortgage in the U.K. is an artifact of the inflationary environment that has prevailed throughout much of the post war period. Low inflation, he predicted, may reduce demand for housing as an inflation hedge and lead to more fixed rate borrowing (Kennedy (1996)). Finally, introduction of the Euro may require re-indexation of some variable rate contracts.

B. Market Shares

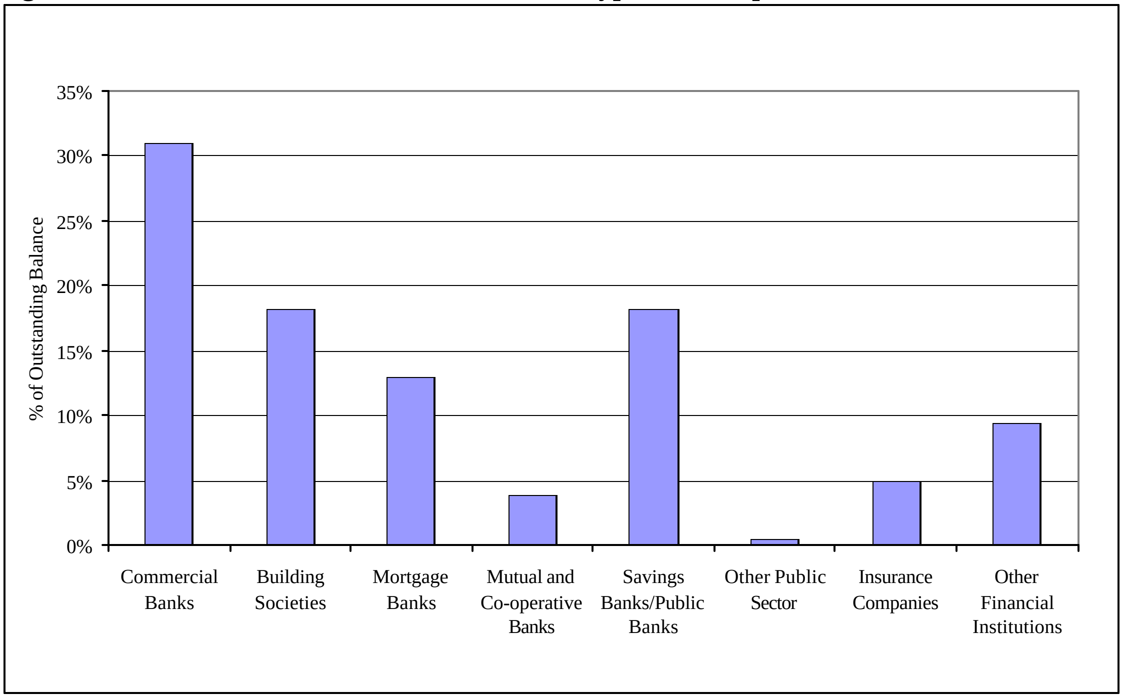
There are a wide variety of lender types providing mortgage credit in the EU. Figure II-7 shows aggregate market shares of different lender types in the EU. Depository institutions (banks, building societies, savings banks, mutual, and co-ops) are the main lenders accounting for over 60 percent of all mortgage credit. Institutions that depend on wholesale (capital market funding), including mortgage banks and central giros, account for approximately 18 percent.

Table II-2 displays the composition of mortgage debt by lender type in the subject countries. Depository institutions dominate the mortgage markets in 11 of the 15 countries shown. Only Germany has a true diversity of lenders with non-depository institutions (mortgage banks, life insurance companies and central giros (Landesbanken) holding 38% of outstanding mortgage debt. Mortgage banks dominate the Danish and Swedish mortgage markets and are active in France, Greece and the Netherlands.[33] Insurance companies are a market presence in Belgium, Germany, the Netherlands, and Norway.

There is considerable diversity by type of depository institution lender. *Commercial banks* have the largest market share in Belgium, Netherlands and Portugal. *Building societies* have the largest market share in Ireland and the U.K.. These institutions, however, operate in much the same way as commercial banks and have been recently converting to commercial bank status in both countries. In fact, the most recent estimate of the building society market share in the U.K is 25%, considerably below the 59% registered at the end of 1996 reflecting the conversion of several large societies including the largest, the Halifax.

33 In Germany, Netherlands, Spain and Sweden the mortgage banks are almost entirely owned by commercial banks. In this sense they are an origination and funding arm of a depository institution.

Figure II-7: Market Shares of Different Lender Types in Europe



Source: European Mortgage Federation, author's calculations. Note: does not include Sweden, Austria and Norway.

Table II-2 European Mortgage Lenders 1995

Country	Lender Types							
	Commercial Banks	Building Societies	Mortgage Banks	Mutual and Co-operative Banks	Savings Banks/ Public Banks	Other Public Sector	Insurance Companies	Other Financial Institutions
Austria	15%	20%	19%	10%	26%			10%
Belgium	70%						10%	20%
Denmark	4%		91%				1%	4%
Finland	88%					10%	1%	2%
France	36%		11%	32%				21%
Germany	13%	11%	18%	13%	38%		7%	
Greece			46%		54%			
Ireland	33%	59%						8%
Italy	100%							
Luxembourg	50%				50%			
Netherlands	72%		9%				19%	
Norway	31%					21%	14%	
Portugal	100%							
Spain	41%		1%		58%			
Sweden	10%		80%				10%	
United Kingdom	37%	59%						4%

Source: European Mortgage Federation, national sources, authors' assessments. Note: Austria and Sweden residential and commercial combined (Austria 1994, Italy 1994, Sweden, Finland 1996).

Specialized *contract savings institutions* (Bausparkassen) are often confused with the traditional form of building societies because their lending operations are based on a special form of the mutuality principle (i.e., over time most savers in the system become borrowers); however, they are typically ordinary joint-stock companies, offering extremely specialized and separately regulated savings and lending features (involving typically below-market rates on both savings and lendings, lending typically as second mortgages only) that differ substantially from the products of, say, British building societies. These institutions are a major part of the Austrian and German housing finance systems.[34]

Savings banks are the largest holders of mortgage debt in Spain and Germany. In Europe, these institutions are typically owned by state, regional or municipal governments; they enjoy both direct and indirect government guarantees that reduce their refinancing costs. In both cases, pricing and products are highly competitive with private commercial banks. The Landesbanken in Germany are also state owned institutions that provide liquidity and long-term finance to the savings banks, enabling them to compete with private banks for long-term fixed rate mortgage lending.

Mutual and co-operative lenders have significant market share in Netherlands, France and Germany. The largest mortgage lender in the Netherlands is Rabobank which is an association of 550 small cooperative banks. Rabobank provides liquidity and financing for the individual cooperative banks. The cooperative banks in Germany have a similar central liquidity facility in DG Bank. Crédit Agricole is the largest mortgage lending organization in France. It is a group of local banks (Caisses Locales) which are cooperative societies with variable capital, operating at a strictly local level. The local banks collect deposits from their members and transmit them to their regional banks. The regional banks are controlled by a central body which provides centralized finance and risk management. These arrangements give small banks capital market access for fund raising and interest rate risk management.

Still a large number of countries have a significant *state-owned institutional* presence in mortgage lending. The National Mortgage Bank of Greece holds over 45% of outstanding mortgage credit. The role of the state in the mortgage market is pronounced in Portugal where the largest mortgage lender Caixa Geral Dépositos, is a state owned bank with a large funding advantage due to the presence of non-interest bearing government accounts.[35] The state also has a significant ownership role, for instance in France through several large commercial banks and the savings bank system, in Italy via the unique indirect ownership system through holdings, and in Germany through the savings banks and Landesbanken. The presence of state-owned institutions can be a major barrier to cross-border competition if such institutions have preferential access to funds.

The institutional mix of mortgage lenders has changed significantly over the years. Traditionally, mortgage lending has been dominated by special circuits in which lending institutions operated with

34 The contract savings institutions in these countries are a special circuit of funding supported by government tax and subsidy incentives. Borrowers contract to save a certain sum and are entitled to future granting of a mortgage loan some time after completing the savings contract. The money raised in this circuit is dedicated to providing loans to contract savers. There is also a contract savings scheme in France that is operated by non-specialized depository institutions. These programs are of major importance to these countries and are discussed in detail below.

dedicated sources of funds and enjoyed either a monopoly on such funds and/or significant tax or funding subsidies.[36] In many countries, commercial banks were either excluded from the mortgage market (e.g., Sweden which generally limits commercial bank lending to one year) or given strong disincentives from entry (e.g., commercial banks in the UK faced very high reserve requirements for mortgage lending until the early 1980s).

Over the years the barriers to entry to the mortgage market in many countries have been dismantled allowing competition from non-specialized lenders, typically commercial banks. On the surface, this trend could be expected to lead to greater use of various forms of variable rate mortgages as depository institutions are funded primarily with short-term deposits. However, development of the capital markets has given many larger depository institutions the ability to fund themselves directly on the Eurobond markets.[37] As noted above, many smaller depository institutions can access the capital markets through centralized refinance facilities. Also, commercial banks have been purchasing or forming alliances with specialized lenders, particularly mortgage banks.[38] The flexibility to use both deposit and capital market financing has enhanced the position of depository institutions relative to specialized lenders (which, by definition do not have access to retail deposits and depend almost entirely on market priced wholesale funds or dedicated savings). Access to low cost retail deposits has given these lenders the ability to under price mortgages (relative to capital market funded institutions) and more flexibility in product design and risk management.

Increased competition can also be accompanied by mortgage rate wars (e.g., Spain, UK) as depository institutions target mortgage borrowers who are prime relationship building customers. This focus has contributed to underpricing of the mortgage instrument (relative to the yield necessary to generate an internationally acceptable return on equity) as lenders attempt to offset low rates on mortgages with fees and returns on other products (e.g., insurance, savings). An example of the strategy can be seen in Belgium where lenders provide rebates to consumer in the form of lower interest rates based on the volume of other business they bring to the bank.

Will this situation continue? In a post-EMU world with increased cross-border lending it is hard to see how it can. Continental European banks are regarded as under-performers on an international basis (McCauley and White, 1997) with above average cost structures and below average returns. In a more

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35 The largest mortgage lender in Belgium is the state-owned OCCH. However it is no longer active and is being wound down.

36 See Diamond and Lea (1992).

37 One reason given for the conversion of building societies to banks in the UK has been the desire to expand use of wholesale funding. Until recently the proportion of total funding from wholesale was limited to 40% of total funding.

38 Mortgage banks have been purchased or absorbed in recent years by commercial banks in Germany, the Netherlands,Norway, Spain and Sweden.

competitive environment it is unlikely that the cross-subsidization that characterizes European mortgage lending at the current time can continue. In this environment it is important to allow a full range of instrument and institution choices as competition will help ensure the best deal for the consumer.

C. Instrument Types

Mortgage instruments are the area of mortgage lending that most likely to be affected by consumer protection. There are a number of dimensions by which to compare mortgage instruments but the most important dimensions are the allocation of credit and interest rate risk.

Credit risk is contractually determined through the loan-to-value (LTV) and payment-to-income (PI) ratios on the loan. These parameters are set at the time of underwriting but vary over time based on changes in loan terms as well as borrower and property characteristics. If the property value is constant, the LTV will decline at a rate based on the amortization formula of the loan. Thus, non-amortizing loans (e.g., endowment mortgages) may have more credit risk than annuity loans. Shorter term loans will have less credit risk than longer term loans reflecting a faster amortization.

Table II-3 reveals major differences in loan underwriting across a sample of EU countries. The typical LTV in France and Italy is quite low by modern mortgage market standards, 60-70%% and 40% respectively. Also, the typical term of 15 years is the lowest in the sample. Although borrower preferences also determine LTV and term, the fact that the legal systems of these two countries make it difficult to repossess in the event of foreclosure is a major factor.[39] Lenders prefer loans with a higher percentage of borrower equity and a more rapid amortization rate in order to reduce the credit risk. This outcome reflects protection of consumers in the event of default. However, in providing this protection for the few borrowers who default, national laws make credit more expensive and less available to a larger set of current and prospective homebuyers.

In several countries (Ireland, Netherlands, UK) credit risk is allocated to third parties through mortgage guarantee insurance. Borrowers can obtain riskier, higher LTV loans if they purchase mortgage insurance through a private company (Ireland, UK) or government agency (Netherlands). Mortgage insurance expands access to mortgage credit but, as discussed in Chapter III, complicates the consumer’s task of product comparison.

An alternative approach to credit enhancement is found through the contract savings in Austria and Germany (*Bauspar*) and France (épargne logement) systems. These systems offer households long-term, below-market fixed rate mortgage loans funded by voluntary below-market, fixed rate savings. The savings are subsidized by governments through bonuses and tax exemption. The loans are typically second mortgages that are packaged with low LTV first mortgages from banks and mortgage banks. As such they provide credit enhancement to the first mortgages reducing the credit risk premium charged by lenders. These contracts present significant consumer disclosure challenges as detailed in Chapter III. In addition, as discussed below, their structure and popularity have important implications for cross-border lending.

The interest rate adjustment process also determines the allocation of credit risk. For a given income, increases in borrower payments that can occur with variable rate mortgages can increase default risk by increasing the payment burden. This has led some countries (e.g., Belgium) to (until recently) ban such loans and currently to require limits (caps) on the maximum payment increase.

Credit risk arising from payment change reflects the allocation of *interest rate risk*. The more frequent the interest rate change, the greater the interest rate risk borne by the borrower. Conversely, the less frequent the change the more interest rate risk borne by the lender. In this dimension there are four major categories of mortgage types available in the EU:

Long Term Fixed Rate: Rate fixed between 5 and 30 years, dominant in France (15 year term) and Denmark (20 and 30 year term), common in Germany (mortgage banks with rates fixed up to 10 years), Greece, and Italy.

Intermediate Term Fixed Rate: Rate fixed between 2 and 5 years (commonly 5 years). Sometimes called a revisable rate loan. Such loans are common in Germany, Belgium, the Netherlands, and have been introduced in the United Kingdom and Ireland. The determination of the interest rate at the end of the fixed interest period can vary. In Germany, the borrower can select the next rate fixing period which can be between 1 and 10 years. In United Kingdom, the loan becomes a reviewable rate loan after the fixed rate period. In Belgium the rate is revised based on contemporaneous 5 year mortgage rates for another 5 years.

Variable Rate: Loans with rates that adjust on a periodic basis with adjustment based on movement in an underlying index. Variable rate loans are common in Italy, Spain, Portugal, France, and Norway.

Reviewable Rate: Loans with rates adjusted at the discretion of the lender and not tied to a particular index. Reviewable rate loans are dominant in United Kingdom and Ireland, also common in Germany and Norway. Reviewable rate mortgages are adjustable rate mortgages for which interest rate change is

39 For example, the typical time needed to foreclose in France is 3 years and in Italy 7 years.

at the discretion of the lender. There is no index specified in the contract governing interest rate adjustments.

There are no comprehensive data available on market share of different mortgage types in the EU. Table II-3 shows approximate market shares by contract type based on 1995 EMF data, selected national information, and inferences about the volumes of different mortgages used by different lenders in different countries. In countries where depository institutions are the dominant lender (Finland, Ireland, Portugal, Norway, Spain, and the United Kingdom) the predominant instrument is either a reviewable rate or a variable rate mortgage.[40] Savings banks in Germany also make use of this instrument.

Table II-3: Predominant Mortgage Products in Europe, an Overview

Country	Main Lenders	Interest Adjustment (Approx. Market)	Typical Term	Typical LTV	Repayment [R] Endowment (E)
Austria	Bausparkassen Mortgage Banks Savings Banks	Some F (Bau-spar), mostly N and R	20-30, Bauspar 10	80%	R
Belgium	Comm. Banks	N (75%) F (25%)	15-20	80%	R
Denmark	Mortgage Banks	V (10%) F (90%)	30	80%	R
Germany	Bausparkassen Commercial Banks Mortgage Banks Savings Banks	F (20%, Bau-spar) N (40%) R (40%)	25-30, Bauspar 10	60-80%	R/E
Greece	Mortgage Bank Commercial Banks	F (30%) V (12%)	15	70-75%	R
Finland	Comm. Banks	V (90%)	10-15	70-80%	R
France	Comm. Banks Savings Banks Mort. Banks	F (80%) V (20%)	15-20	70-80%	R
Ireland	Building Societies Comm. Banks	R (57%) F (43%)	20-30	80%	R
Italy	Comm. Banks	V (40%) F (60%)	15	40%	R
Luxemburg	Public Banks Commercial Banks	Mostly R, some V.	15-20	n.a.	R
Netherlands	Comm. Banks Insurance Cos.	V (10%) N (65%) F (25%)	30	75%	E/R

40 Reviewable rate mortgages are commonly offered by depository institutions (in particular building societies in Ireland and the UK, savings banks in Germany). Research by Diamond and Lea (1992) suggest that interest rates on reviewable rate mortgages are determined as a spread over the average cost of retail savings. In the case of the UK the spread is relative constant but as discussed in Chapter IV in Germany there has been an upward bias in the spread over the life of the loan. Generally speaking,, rate changes on such mortgages are less volatile than rate changes on variable rate mortgages indexed to money market rates (e.g., LIBOR, government Tbill rates).

Norway	Commercial Banks Savings Banks Public Banks	R (90%) N (10%)	15-20	80%	R
Portugal	Comm. Banks	V (100%)	20	80%	R
Spain	Savings Banks Comm. Banks	V(80%) F (20%)	15-20	70-80%	R
Sweden	Mortgage Banks Comm. Banks	Mainly R and short-term N.	20-30	70-75%	R
United Kingdom	Building Societies Comm. Banks	R (70%) N (30%)	25	90-95	E/R

Source: own survey, EMF. Notes: Fixed (F) Renegotiable (N), Variable (V) Reviewable (R). Fixed: rate fixed until final maturity. Renegotiable: rate not fixed over entire term, but more than 1 year. Variable: rate adjustable according to index, reference rate. Reviewable: rate adjustable, discretion of lender. Author's definitions and overview. For details of the national systems, see Annex.

The two anomalies are France and Italy. The majority of the market-rate mortgage loans in France are fixed rate and amortizable over 15 years.[41] Although commercial bank lenders have access to the capital markets for a degree of interest rate protection (e.g., through interest rate swaps or issuance of intermediate term notes) French lenders absorb a considerable degree of interest rate risk as a result of their mismatch.[42] Variable rate mortgages are allowed but appear to have a consistently low market share (15-20%). Depository institutions in both Belgium and the Netherlands make heavy use of renegotiable rate instruments. Fixed rate loans still account for a majority of contracts offered by banks in Italy.

Box 1 Securitization and Mortgage Instrument Design

The type of instrument used has a significant effect of the potential for capital market funding of mortgages, and indirectly on cross-border lending. Reviewable rate mortgages are intrinsically difficult to securitize as the rates on the loan are determined at the lender's discretion and not necessarily in line with the movement of other rates in the financial market. For example, centralized lenders entered the UK during the 1980s, financing mortgages through the issuance of MBS. During the 1987-1989 period they enjoyed a relative cost of funds advantages and built a 13% market share of new originations. However, when a sharp rise in market rates in 1988 restored the funding advantage of retail funded building societies, the centralized lenders were hit with heavy prepayments as they had to adjust their rates when the underlying funding rate index (LIBOR) moved whereas their principal competitors (banks and building societies) did not have to adjust (as retail savings rates only sluggishly responded to changes in market interest rates). This hurt the centralized lenders both financially (in many of the securities they were required to replace some of the mortgage collateral with lower rate new loans) and in originations (as rates set as a spread to LIBOR were less competitive). Unrestricted prepayment is also a barrier to securitization and thus capital market funding of mortgages. The call option inherent in prepayable mortgages is difficult for investors to price and (risk) manage. Both securitization and general capital market funding of mortgages will benefit from restrictions on the right of early repayment (either penalties or exclusion as discussed in Chapter III). A final point is that increased standardization

41 Most subsidized loans are fixed rate. Up to 50 percent of free market loans are now variable rate (higher percentage for specialized lenders).

42 The mismatch is reduced by the contract savings funds which consitute a majority of funds used for housing loans. Most of these are subsidized loans are fixed rate whereas a higher proportion of free market loans are variable rate.

of contracts (documentation and underwriting including disclosure) will foster increased capital market funding of mortgages through greater liquidity in mortgage-related securities.

In countries where mortgage banks and other centralized lenders have a significant market presence, the intermediate and long term fixed rate mortgage is dominant. In Denmark, over 90 percent of mortgage loans are long term fixed rate and in Sweden over 55 percent of mortgage loans have rates fixed 5 years or more. In Germany, both intermediate and long term fixed rate contracts are offered by the mortgage banks and Bausparkassen with a combined market share of approximately 30 percent. Savings banks recently have been offering intermediate term loans with fixed rate periods up to 10 years, either refinanced by the Landesbanks or on a mismatched basis. The dominance of an intermediate term fixed rate instrument in Belgium and the Netherlands reflects the prohibition until recently of variable rate mortgages in Belgium and the historical importance of mortgage banks (also until recently) in the Netherlands.

It is striking that only Germany has significant market shares of both variable and fixed rate mortgages. The use of purely reviewable rate mortgages has declined in recent years as many savings banks offer short-term fixed interest loans similar to those offered by the mortgage banks. Although UK and Ireland lenders offer initial fixed interest periods that can be as long as 5 years, the loan reverts to a reviewable rate basis after the initial period. The differentiation of markets by fixed versus variable rate contract types is due to several factors including consumer expectations of interest rates (e.g., in the past, fixed rate contracts have been more common in both Portugal and Spain but have substantially reduced market share as interest rates fell sharply in the early 1990s), risk of offering fixed rate products by domestic lenders (e.g., in Spain the government introduced the subrogation law allowing borrowers to switch lenders (prepay) with a maximum penalty (discussed in Chapter III) and in so doing voided existing contracts that did not allow for early repayment) or tradition (UK – VRM, Germany FRM although relative interest rate volatility is an equally convincing explanation).

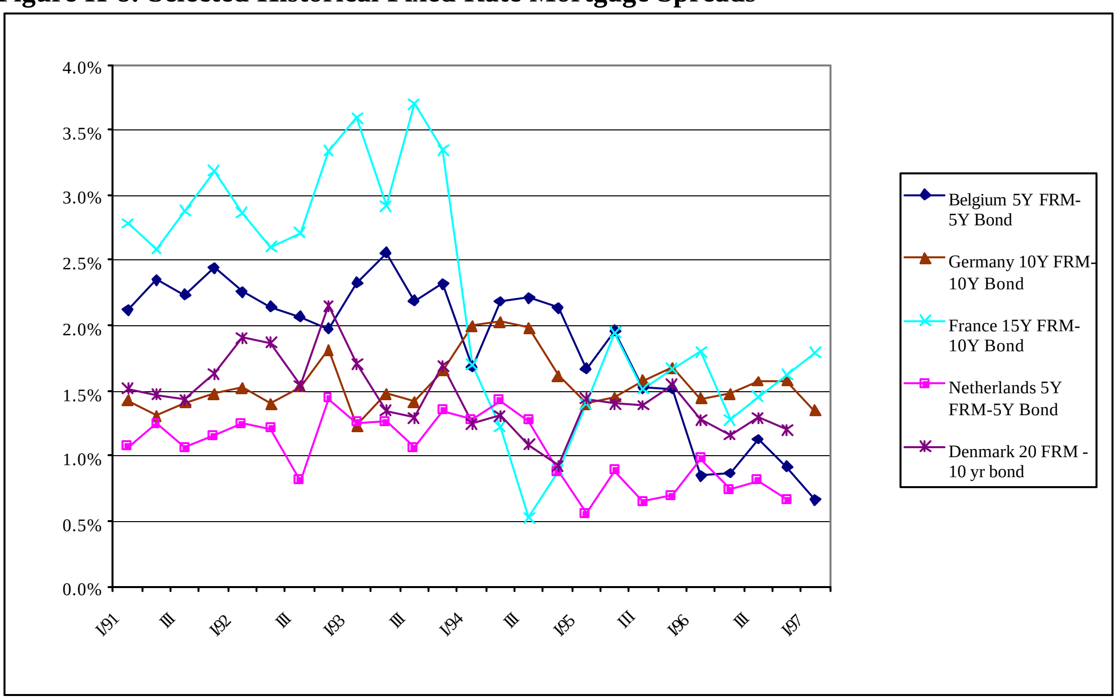
Regulation has an influence on the type of instrument offered. In three countries, Belgium, Finland and Spain, variable rate loans must be indexed to a market rate of interest which precludes reviewable rate contracts. Until recently, variable rate contracts were not allowed in Belgium.

D. Mortgage Pricing

Mortgage rates in different countries are difficult to compare across countries for a number of reasons. Definitions of interest rates vary, interest rate levels vary with the maturity of the loan, the extent to which the rate varies (i.e., fixed versus variable rate loans), the level of inflation (if comparing nominal interset rates) and the type of lender. In addition, the legal framework for mortgage credit is different in each country creating different risks and costs.

Some of these factors can controlled for by expressing mortgage interest rates relative to a benchmark yield in the national economy. The most common comparison for fixed rate mortgages is with government bond yields of comparable duration as many fixed rate loans are funded on a wholesale basis (e.g., through bonds). The most common comparison for variable rate mortgages is with deposit rates or average funding costs of depository institutions as such loans are mostly offered by depositories funding themselves with retail deposits. This measure eliminates the effect of maturity and inflation. The magnitude of the spreads reflects a number of factors including the degree of competitiveness, the relative risks of mortgage lending, the presence of subsidies, and the relative efficiency of mortgage lenders.[43] Consumer protection measures enter only indirectly, through differences in credit risk premiums. Figure II-8 and Figure II-9 show relative spreads for select countries by types of interest rate contract (fixed versus adjustable). The fixed rate comparisons are with comparable maturity (5 or 10 year) government bond yields and the ARM comparisons are with average national deposit rates.

Figure II-8: Selected Historical Fixed Rate Mortgage Spreads



Source: European Mortgage Federation, International Monetary Fund, national sources, authors' calculations.

Figure II-8 examines fixed rate spreads over time in Belgium, Denmark, France, Germany, and the Netherlands from 1991-1997 (countries in which fixed rate instruments are dominant). Spreads have

43 For a detailed review of mortgage spreads in Denmark, France, Germany and UK see Diamond and Lea (1992).

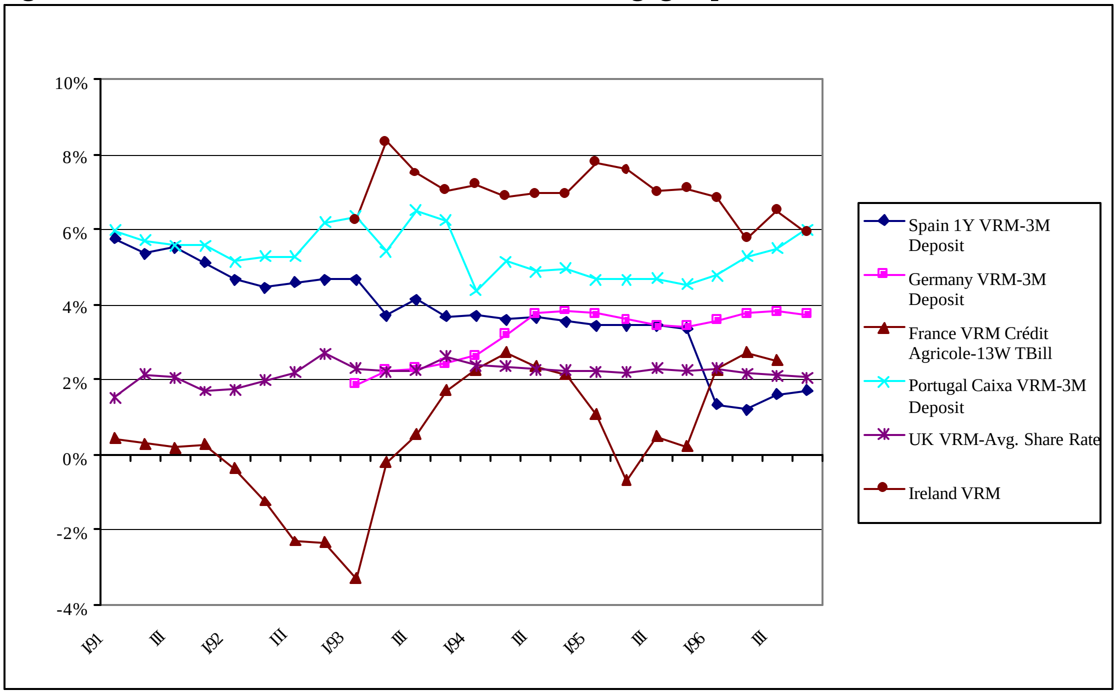
tightened during the past two years in Belgium and the Netherlands, reflecting increased competition in the mortgage markets. In both cases, current spreads are less than 70 basis points which would be insufficient to cover costs of origination, servicing, and risk if the lending institutions were funding on the capital markets. However, as noted above, the dominant lenders in both countries are commercial banks which have lower cost retail deposits and thus wider spreads to actual funding costs. Access to such funds gives these lenders a pricing advantage over lenders funding exclusively on the capital markets.[44]

German spreads have been stable, typically 150 basis points except for a brief interval at the beginning of 1994. These spreads primarily reflect operating costs and profit margins as the lending institutions (mortgage banks) bear very little interest rate risk as they are match funded (typically 5-30 bp over government) and borrowers do not have the right of early repayment. In addition there is very little credit risk since most mortgages 60% LTV or less. Note that Danish spreads are lower despite the fact that borrowers have an unrestricted right of early repayment. This anomaly relates to apparent underpricing of the option by Danish institutional investors (see Chapter III).

French spreads have been much more volatile over the time period although they have stabilized during the past two years. Most fixed rate mortgages are made by commercial banks which fund them with deposits and PEL (see box below on subsidies), exposing them to significant interest rate risk.

44 In fact many mortgage banks in the Netherlands have been purchased by or merged with commercial banks in recent years.

Figure II-9: Selected Historical Variable Rate Mortgage Spreads



Source: European Mortgage Federation, International Monetary Fund, national sources, authors' calculations.

Spreads on variable rate mortgages in countries where such instruments are dominant or significant are shown in (Figure II-9). Variable-rate mortgage spreads to deposit rates are wider than those between fixed rate loans and government bond yields. Wider spreads reflect the ability of depository institutions to fund with retail deposits which are typically cheaper than capital market funding sources. Generally, the wide spreads overstate profitability as they do not reflect non-interest costs associated with deposit funding. The true cost must include the marginal funding costs for branch operations and deposit rate insurance. Together these may add 50 to 100 basis points to funding costs, depending on the size and efficiency of branch systems.

The UK is generally viewed as a highly competitive and relatively efficient mortgage market (Diamond and Lea). The spread between the mortgage rate and average share (deposit) rate has been relatively stable at 200 bp. The stability of this spread reflects the practice of UK lenders of setting rates on reviewable rate mortgages at a fixed spread over average retail deposit rates. Spreads on mortgages to new borrowers in the UK are significantly less (at least 100 basis points) reflecting widespread initial discounting.

By way of contrast, spreads on variable rate mortgages in Germany are nearly double those of the UK. Spreads rose significantly in 1994 (from less than 200 to nearly 400 basis points) as mortgage rates (which are unilaterally set by lenders) have not declined to the same extent as savings rates. The spread difference most likely reflects differences in both the relative efficiency and degree of competition in the two countries.

They are much wider in Portugal and Ireland indicating less efficient markets. Spreads have fallen to less than 200 basis points in the competitive Spanish market reflecting the twin effects of the rate decline and the change in the law allowing more easy prepayment. French variable rate spreads are difficult to interpret particularly given the substantial effect of subsidized funding noted below.

The relative pricing of mortgages reflects the funding sources of lenders. Given the pricing advantages of lenders funded with retail deposits it is not surprising that depositories are the dominant lenders in most countries. Furthermore the price advantages enjoyed by domestic depository institutions is a major factor explaining the lack of cross-border lending. In order to compete with domestic depository institutions it has been necessary to create deposit taking branches within the country (see below). EMU is likely to reduce the funding advantage of depository institutions and thus the relative spreads in two ways: Increased cross-border competition for savings will erode retail funding advantages and the costs of conversion will raise depository institution operating costs.

E. Differences Between Mortgage and Consumer Lending

What are the key differences between real estate lending and mortgage lending on the one hand, and non-real-estate consumer lending on the other hand?

1. Differences in Collateralization

A distingushing characteristic of mortgage lending is a special collateralization mechanism, with long-standing legal and economic national traditions that protects the creditor in a particular way from the consequences of a default of the borrower[45]. In fact, by threatening the potential transfer or sale of the main dwelling of the household and by establishing the need to identify and transfer property titles with potential consequences for mortgage originators and mortgage-backed bondholders, a much wider set of legal spheres are addressed than if non-mortgage assets are considered for collateralization.[46] Special debt instruments that are widespread in the economies surveyed, such as mortgage-backed securities and mortgage bonds, require the mortgage lien as their central credit enhancement device, regardless of

45 We abstract here from the in the European context rather theoretical cases of mortgage collateralization of loans obeying Article 2 of the Consumer Credit Directive. In the US, and more recently the UK, home equity lines of credit have been introduced that imply the collateralization of any consumer loans by a mortgage.

the loan purpose. These special refinancing instruments pose special conditions on consumer protection legislation (e.g., possibility of assignment/transfer of the loan to a third party w/o major transaction costs). The mortgage, not the loan purpose, is in most aspects the key legal binding element between the three implicit contract partners, consumer, creditor, and bond investor.

The speciality of mortgage collateral is recognized in bank regulation and supervision, where residential mortgage lending as well as mortgage-collateralized bond issuances enjoy a preferential capital treatment, lowering the cost of funds of the loan vis-a-vis non-real-estate consumer loans. The differences in credit risk content that supervisors assume thereby are, however, seldom tested econometrically[47].

The fact that the collateral is in the form of the borrower's principal residence is another important distinction. This has led legislatures and courts to apply protections for the borrower in the event of loan default to ensure that repossession and eviction is used only as a last resort. As noted above, differences in national legislation regarding foreclosure and repossession are a major factor in the credit risk of mortgage lending and as discussed below a major barrier to cross-border lending (not regulated in the CCD). Also, such differences are causal for the vastly different levels of market penetration in Europe.

2. Differences in the Significance of the Credit Sectors

The Report on the Consumer Credit Directive shows that average non-real-estate consumer credit loan sizes have strongly grown over the past 15 years in some countries, such as Italy, Ireland, France, Greece, and Spain[48]. Table II-4 gives an approximation of the two credit markets around 1990/1991. Taking those countries with available data for both markets (which includes all major mortgage markets, except Denmark), outstanding residential mortgage loans are about 4.5 times the size of outstanding consumer loans. Comparison is seriously constrained because of numerous delimitation and definition problems.

46 This argument also applies to close substitutes to mortgage lending, for instance real-estate leasing, where again the fundamental difference to other consumer lending lies in the special default mechanism.

47 For Sweden, the team obtained concrete estimates: the loan recovery ratio in case of default of mortgage loans is estimated at 75%, for other consumer credits at 5-25%.

48 The method of measurement of the Report is, however, inaccurate as it relates total consumer lending in the economy to all households, not households with consumer loans.

Table II-4: Approximation of Total Outstanding Non-Real-Estate Consumer Loans and Residential Mortgage Loans around 1990/1991, Selected Countries

	Consumer Loans	Residential Mortgage Loans
	billion ECU, 1990/1991	
Belgium	5.8	33.0
Denmark	16.2	n.a.
France	55.0	233.2
Germany	142.0	557.0
Greece	0.3	3.5
Ireland	3.1	7.5
Italy	28.0	50.4
Netherlands	7.5	103.0
Portugal	n.a.	7.2
Spain	14.5	63.9
United Kingdom	75.0	456.0

Source: Report on the Consumer Credit Directive, EMF. Notes: Data on mortgage lending in Denmark pool residential and commercial lending.

In mortgage lending, typical loan sizes in Europe vary between approx. 50,000 (Italy) and 130,000 ECU (Germany) (see Table II-1, 1996). By 1990/1991 average consumer loan sizes varied between 1,200 (Netherlands)[49] and 5,500 ECU (Germany). However, higher average loan amounts are not a necessary determinant of real-estate or mortgage lending, in both logical directions: individually small real-estate or mortgage loans are the rule for many countries (e.g., Pret à taux zero in France, Bauspar loan in Germany), while non-real-estate consumer loans are not necessarily limited to the ECU 20,000 limit. In countries with a strongly developed consumer lending culture, non-real-estate consumer loans easily exceed real-estate loans at some point in time of the consumer's lifecycle: witness the increasingly popular concept of home equity loans in the US.[50] Taking loan size as an exact cutting-edge for the differential treatment of a set of rights and options is hardly justified. The quantitative indicator that would demand consumer protection attention is the relation between total indebtness of households and income, here the more serious consequences of a loan default in the case of mortgage lending (loss of dwelling) play a role.

3. Differences in Contract Duration and Interest-Rate Risk Allocation

Long contract durations as well as long interest-rate binding periods establish factual, but not necessary differences between real-estate and non-real-estate consumer lending. There are numerous examples of fast repaying real-estate loans, in particular second mortgages or Bauspar loans, as well as topping-up loans for dwelling purchase, renovation, or modernization. Even first mortgage loan durations in the EEC

49 Italy 1.350 ECU

countries vary between 10 (Finland) and 60 (Sweden) years (see Table II-3). Predominant interest-rate fixing periods vary between 1 (France, Spain) and 30 (Denmark) years. Also, the share of adjustable rate lending shows great variations, from dominance of the market in United Kingdom and Finland, to mixed systems such as Belgium, Ireland, Spain, and Portugal, to low significance in France, Denmark, Greece, Sweden, and Germany. Reviewable interest rate loans, as opposed to index-adjustable interest rate loans appear to be a special feature of mortgage credit.

The generally longer term of mortgage compared to consumer loans implies a difference in refinancing. For example, in some countries there is significant capital market funding of housing through the mortgage bond markets. However, it is neither universal nor exclusive. There is growing use of the capital markets for funding of consumer loans through asset-backed securitization.

Concerning these features, the variations among mortgage loan types are certainly greater than between mortgage/real-estate consumer loans and non-real-estate consumer loans, which makes treatment in a directive more complex (in particular, as we will see in the case of APRC). Non-real-estate consumer loans may have long durations[51], fully amortizing repayment profiles and long implicit or explicit interest-rate binding periods. In countries with predominant adjustable rate or short-term fixed rate financing of mortgages, the differences in interest-rate risk allocation are negligible.

The absence of necessary differences between non-real-estate and real-estate consumer loans with respect to contract duration and interest-rate risk allocation is important when judging key issues, such as early repayment and rescission rights. As we will see, a differential treatment of non-real estate consumer loans and real-estate/mortgage loans would not be justified on the basis of the refinancing techniques, but on the fact that early repayment, if not cushioned by compensation payments, creates a loss potential of the asset value held by the lender that increases credit costs. This feature is unrelated to the loan purpose, and to a large extent also to the type of collateralization.

4. Transaction Costs

There are more components to the mortgage transaction than the consumer loan transaction. Typically there are appraisal fees, registration fees, credit report fees, title insurance or notary fees, application

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50 There is a tax incentive motive for this as interest for these loans is tax deductible whereas interest on consumer loans not secured by a mortgage is not.

fees, lawyer's fees, etc. In addition, lenders can buy down the mortgage rate (points/fees trade-off, disagio). Sometimes these fees are imbedded in the rate and sometimes they are charged separately (although the borrower may be able to finance). Some of the costs are lender specific, some are government related, and some are fees for third party service provision. For the most part these are property specific and thus differentially affect mortgage as opposed to non-real-estate credit. Typical charges for mortgage lien registration and notary in the member states vary widely, from modest amounts (0.4% of the mortgage in Luxembourg and Germany) up to as much as 4% in Belgium. These differences are a major obstacle to European price (APRC) and product comparisons.

5. Special Subsidy and Tax Treatment of Mortgage Lending

A major difference between consumer and mortgage lending is the subsidization of the latter. European governments support homeownership through a variety of tax and subsidy schemes. As detailed by the European Mortgage Federation (1997), aid through taxation provides a far greater contribution than direct aid to the budget of potential buyers (country selection based on EMF findings and meant to be illustrative of mortgage-related subsidies).

A major form of tax aid is through the deductibility of mortgage interest from taxable income for individuals. As shown in Table II-5, at least 13 EC countries allow at least partial interest deductibility.[52] Aid in this form lowers the after-tax cost of capital for home purchase and thus incents greater use of mortgage debt by households. Tax relief is accorded to all national citizens regardless of lender. However, in some countries (e.g., UK) a lender must be registered with the national tax authority to offer tax relief at source.

The major issue associated with tax treatment of homeownership expenses is whether deductions are allowed for non-national homebuyers. Restriction of favorable tax treatment can represent a barrier to the free movement of households within the EU. However, it is not a barrier to cross-border lending from the standpoint of lenders.

51 There is a lack of empirical data concerning the typical durations of consumer loans. The Bundesbank, for instance, uses durations of between 36 and 60 months to derive their interest-rate statistics opn hire-purchase loans. Considering the fact that these loans are typically fixed-rate, typical interest-rate binding periods would hence not be too different from that of German mortgage loans, at least in phases of high interest-rates. The situation in other European states may be different, due to the treatment of early repayment.

Table II-5 Tax Treatment of Mortgage Interest Payments, Selected Countries

Country	Interest Deductible	Limits
Belgium	Yes	Up to amount of property income received (rental value (40% of tax value)
Denmark	Yes	Maximum tax rate for interest deduction being reduced to 44% by 1998.
Germany	No	N/A
Greece	Yes	Up to 25% of family income
Spain	Yes	Up to 5,000 ECU for individual, 6,250 for cumulative
France	Yes	25% of interest amount; limits based on new or existing
Ireland	Yes	3,100 ECU relief per annum per person (6,200 per couple)
Italy	Yes	Up to 7 mil. Lira (max. 22% of interest payments)
Luxembourg	Yes	LUF 27,000 per family member (max. household LUF 135,000)
Netherlands	Yes	None
Austria	Yes	ATS 40,000 per taxable person
Portugal	Yes	297,000 PTE
Finland	Yes	Max. 28% deduction
Sweden	Yes	30% of total debt interest up to 100,000 SKR annually
UK	Yes	Up to L 30,000 at standard rate of tax (15%).

Source: EMF.

The tax system also favors certain products in particular countries. For example, tax relief on dividends for life insurance policies can incent endowment mortgages (e.g., the Netherlands).

Mortgage-related direct subsidies are also quite common in the EC. These include reduced interest rate loans, government guarantees, and eligibility of homeowners to housing allowances or benefits. These benefits are only available to residents and specific to homeownership. Interest rate subsidies can lower the cost of capital and thus incent borrowing. Also, they can reduce the credit risk of mortgage lending by lowering the market LTV.

Subsidies that are paid directly to borrowers or reimbursed on a 1:1 basis to lenders are in principle non-distortionary to the financial system. As noted by the EMF subsidies granted to persons do not seem to represent major distortions of competition. However, if subsidies are not delivered through all lending institutions, those acting as distribution agents do have a competitive advantage through the customer relationship that allows them to cross-sell other products. EMF (1997) cited several examples including

52 There is a partial offset of the tax advantage to mortgage interest in several countries (Belgium, Denmark, Spain and Netherlands) due to the taxation of the imputed rental value of the house. In practice this offset is quite modest as the imputed rent is based on very low estimates of market value (e.g., Belgium approximate market value of the year 1975, Denmark 2% of the market value).

Portugal where subsidized loans can be distributed only by domestic banks and France where until very recently, Credit Foncier de France had a monopoly on distributing the PAP loan. [53]

Box 2 How European Governments Deter Entry - the French Example

A major barrier for cross-border lending is the presence of funding subsidies for certain classes of lenders. The subsidies lower the cost of funds for the privileged lenders and give them an advantage over non-privileged lenders. An example of such an advantage is the contract savings (Plan E'Pargne Logement (PEL)) system in France. French depository institutions (commercial, cooperative and savings banks) are allowed to solicit tax advantaged PEL savings accounts. The saver agrees to save a certain sum and is eligible for a mortgage loan at a fixed spread over the account at the time of fulfillment. Because the rates on the accounts are set at a level to be competitive with alternative savings rates on an after-tax basis, they represent a below-market funding for the bank (as the government is paying part of the return in the form of lost taxes). The savings collected under this program can be used for any type of mortgage lending. Access to funds has allowed banks underprice mortgages relative to other forms of credit (e.g., rates at or below comparable maturity government bond yields). This pricing behavior acts as deterrent to both domestic competitions (e.g., from specialized lenders that do not have access to funds) and to cross-border competitors. The only realistic way to compete on a large scale basis in the French market is to establish a French bank that can offer PEL accounts. Establishing a bank or bank is a costly way to enter a market and thus deters cross-border competition.

More importantly, subsidies that endow below-market rate funding to certain lenders convey a pricing advantage in the market. A more specific example is the case of French depository institutions which have exclusive rights to mobilize tax-favored contract savings (EL) funding (see Box 2). The contract savings is typically lower cost than term deposits and can be used to fund all types of housing lending. During the 1990s French lenders have used these funds to price fixed rate mortgages at or below comparable duration government bonds. Access to such funds, if restricted to certain lenders, can constitute a substantial deterrent to cross-border lending.

Likewise, European countries which limit competition for savings, for example through exclusion of mutual funds or prohibitions against payment of interest for certain (current) accounts, also bias the lending process in favor of domestic depository institutions. Such limits tend to favor the traditional repositories for savings who can use low cost funds to cross-subsidize mortgage lending.

F. Cross-Border Mortgage Lending

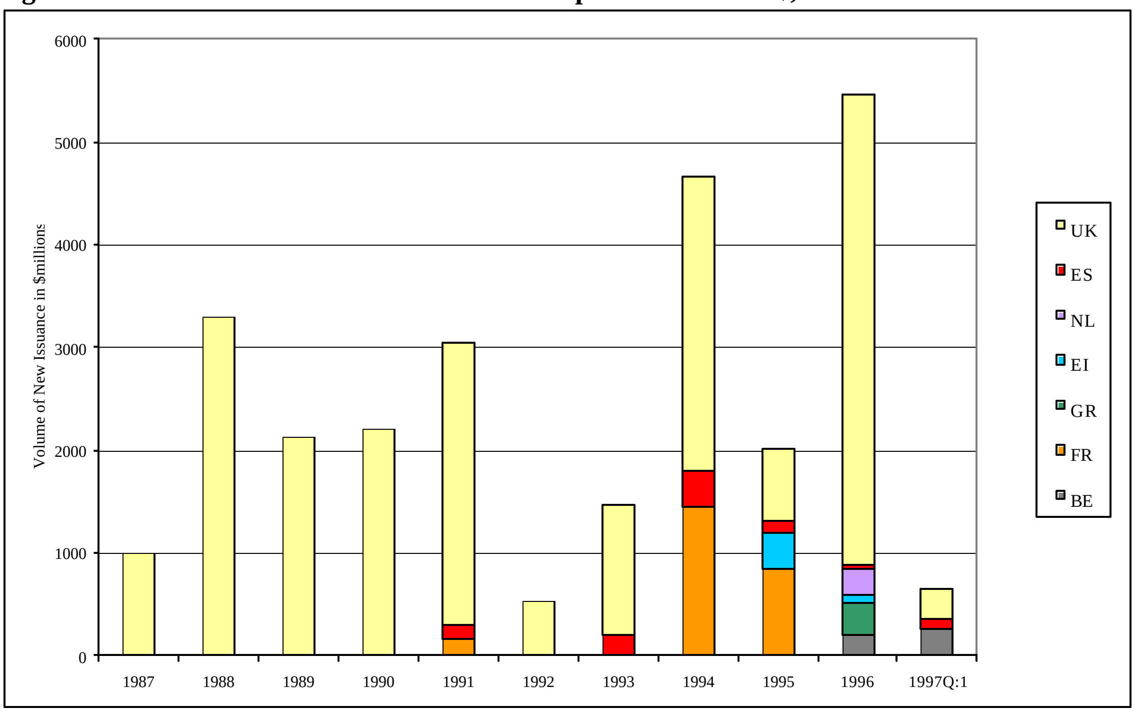
The information provided above shows that European mortgage markets are highly fragmented and national specific. The characteristics of dominant lenders and contracts differ significantly across

53 The PAP loan has now been replaced by the zero-rated loan which can be distributed by all state-approved credit institutions after completion of a competitive procedure. Depending on the approval process this change may be postitive in opening up competition in the French market.

member states. Within countries there appears to be significant choice of product and lender for consumers, even if a particular contract type or institutional lender type dominates.

Access to low cost retail deposits is a major factor in explaining the domination of many mortgage markets by domestic depository institutions. Depository lenders can use such funds to underprice loans offered by lenders funding on the capital markets and thus reduce price competition. Capital market lenders offer alternative products (e.g., long term fixed rate mortgages) to depository lenders. However, larger depositories typically access the capital markets to match fund such loans, or as in the case of French banks use long term subsidized funds for this purpose.

Figure II-10 Volume of MBS Issuances in Europe in Million US$, 1987-1997



Source: Bank of Ireland.

The expansion of securitization, either in its on-balance form as mortgage bonds, or off-balance as mortgage-backed securities (MBS), as a viable funding option in a number of member states provides a vehicle for expanded cross-border lending (see Figure II-10 for MBS issuances in Europe). For instance, with off-balance securitization as a funding source, a lender could set up an operation in a member state originating loans through intermediaries, providing servicing either in-country or abroad and fund itself through issuance of mortgage-backed securities. On-balance securitization through mortgage bonds, with its typically tight regulatory framework, could also provide better access to wholesale finance for lenders in many European countries that typically refinance housing loans through retail sources (mainly deposits). The ability to introduce securitization will depend on the relative competitiveness of retail versus wholesale funding. Regulatory impediments for securitization in either form still abound.

The imposition of withholding tax on interest earned on mortgages made in a particular country and remitted to another country can raise the cost of funds for cross-border lenders.[54] This in turn can force cross-border lenders to charge higher mortgages rates rendering them less competitive. In fact, much of this effect may be mitigated by cross-border treaties on withholding, an analysis of which is beyond the scope of this study. However, a number of lenders cited withholding tax concerns as a rationale for establishing a branch in a foreign market instead of using lower cost distribution networks.

Regulatory treatment of funding types can also affect cross-border lending. For example, lenders wishing to issue mortgage bonds called Pfandbrief must be registered and regulated as mortgage banks in Germany. A lender structuring its bonds in exactly the same fashion as the Pfandbrief could not call them by this name and would end up having to offer higher yields than registered mortgage banks. This practice is based on safety and soundness considerations by the domestic regulators. The EMF has cited a number of additional barriers to capital market access. Access to local capital markets can be an important piece of a cross-border lending strategy as a frees lenders from having to establish expensive deposit-taking branches in a country.

Domestic consumer protection regulation has the potential to block some product types and indirectly some lender types. For example, a universal right of early repayment may under circumstances explored below reduce the ability of lenders that match funds with non-callable debt from competing in such markets. Too narrow statutory limits on prepayment penalties reduce price competition by increasing the risk of offering long-term fixed rate contracts and deep initial period discounts.[55]

There is no European-wide data source on magnitude of cross-border lending. The team interviewed lenders in a number of countries who have been involved in or contemplated cross-border initiatives (Ireland, Germany, Denmark, UK). In almost all cases, cross-border initiatives focused on depository institutions establishing branches or subsidiaries in other countries to obtain funds and make loans. In these examples, the foreign institution simply adopts the local contracts rather than introducing its home country contract. This approach is not true cross-border lending although supplemental funding may come from the foreign parent. The main reasons given by lenders for choosing this approach over a true

54 When debtors are located outside a country, tax liability depends on the network of double tax treaties that have been entered into by EU countries. Such treaties are far from perfect, however, and in some countries cross-border competitors prefer to obtain funds locally and pay tax only on net profit (or re-invest such profit in the subsidiary).

55 Lenders use prepayment penalties as a device to hold borrowers to the contract for a longer period of time to „claw back“ the initial discount. A key consumer protection question is whether the magnitude and length of such penalties is excessive. As discussed in Chapter IV, in countries with market determined prepayment penalties (e.g., UK) there is evidence of prepayment penalties well in excess of the value of the option. Both lender and consumer groups expect such penalties to be challenged under the Unfair Terms Directive.

cross-border lending strategy (e.g., using intermediaries to originate loans serviced and funded by a foreign institution) include:

- Consumer *familiarity* with known institutions and products is important for larger, long-term contracts;
- *Security* is nation-specific. Registration, valuation and foreclosure systems vary across countries and offer varying degrees of certainty to lenders affecting willingness to lend and pricing. This necessitates a local presence to service, collect and enforce mortgage contracts;
- *Information* is local. Indigenous lenders have better information on borrowers and properties to underwrite borrowers and price risk This can be offset to some degree by the presence of centralized information sources (credit bureaus, house listing services) if such information is available to all competitors;
- *Exchange rate risk* is still significant and can be most cost effectively managed by developing domestic currency funding sources;
- *Lack of standardized disclosure*: The only uniform piece of information presented to borrowers is the APRC. As discussed in more detail in Chapter III, the APRC is inadequate for consumers to effectively compare complex mortgage products, particularly when such products are packaged together. The lack of uniform disclosure and the difficulties of comparing complex products lead lenders to either compete on price with local products or avoid markets with significantly different product designs altogether.

An example of the difficulties experienced by foreign lenders entering national markets is shown in Germany (Box 3).

There is a growing use of intermediaries in origination of mortgage loans in Europe. Intermediaries, including loan brokers, insurance agents, and financial counselors, are the dominant source of new loans in Ireland, Netherlands, the UK, and are significant in Europe. The team has not examined the issues related to intermediary lending in detail.

A major issue is whether they are subject to the regulations and codes of conduct to which more formal lending institutions are subject. In the UK all lenders recently approved a Code of Conduct governing disclosure to and treatment of borrowers. However, at the time of this writing, intermediaries were not covered and there are no intermediary organizations to facilitate their acceptance. The Netherlands has addressed this problem by requiring lenders to monitor intermediary originations and to stop doing business with those who do not abide by the Code of Conduct.

Box 3 How European Governments Deter Entry: the German Example

A major element of the German mortgage market is the contract savings (*Bauspar*) system. Participants in this system are eligible for both tax incentives and subsidies conditioned on fulfilling a savings contract. Fulfillment of the contract entitles the saver to a mortgage loan (typically a second mortgage that is combined with a first mortgage offered by a different lender). The contracts are very popular with a majority of households having one or more savings contracts. By law, the tax benefits of the contracts are available only for German citizens. Also, they can be provided only by approved specialized entities (*Bausparkassen*) registered in Germany (the same is true for institutions (mortgage banks) desiring to offer first mortgage loans funded by registered mortgage bonds (*Pfandbriefe*)). The products cannot therefore be offered cross border (into Germany) and an institution wishing to offer the contracts must establish a *Bausparkassen* within Germany.

The management board (*Vorstand*) must be approved by the regulator (BAK) and must be comprised of German residents, fluent in German, and of suitable experience (defined as 3 years experience in a similar position on the management board of another *Bausparkasse)*. Furthermore, under German corporate law, the Supervisory Board (*Aufsichtsrat*) which represents shareholders, has power only to set long-term strategy and policy and to hire and fire the management board. It cannot be involved in the day-to-day management. In effect this means that an outside owner has diminished control over the institution and cannot bring in its own management.

The *Bausparkassen* offer both contract savings and loan programs. The contracts are required to have approximately a 2 percent margin. The regulator must approve every tariff (product) offered by the *Bausparkasse* and can reject general margin reductions as unsafe and unsound. As a matter of practice they send new tariff proposals to the trade association which circulates them for comment to the other members of the organization. Thus it is difficult to launch a new product without the competition knowing and implicitly approving the product.

In summary, although a foreign institution can enter the contract savings and lending market in Germany, the controls exercised by the regulator on safety and soundness grounds increase the expense of entry, reduce the ability of the owner to control the management of the institution and reduce the potential to compete on the basis of price or product design.

The role of intermediaries is important in the development of cross-border competition. Lenders in one country use intermediaries in another to distribute their product, thus avoiding the high fixed cost of a branch origination system.[56] It is important that intermediaries be subject to the same disclosure requirements as lenders to ensure a level playing field.

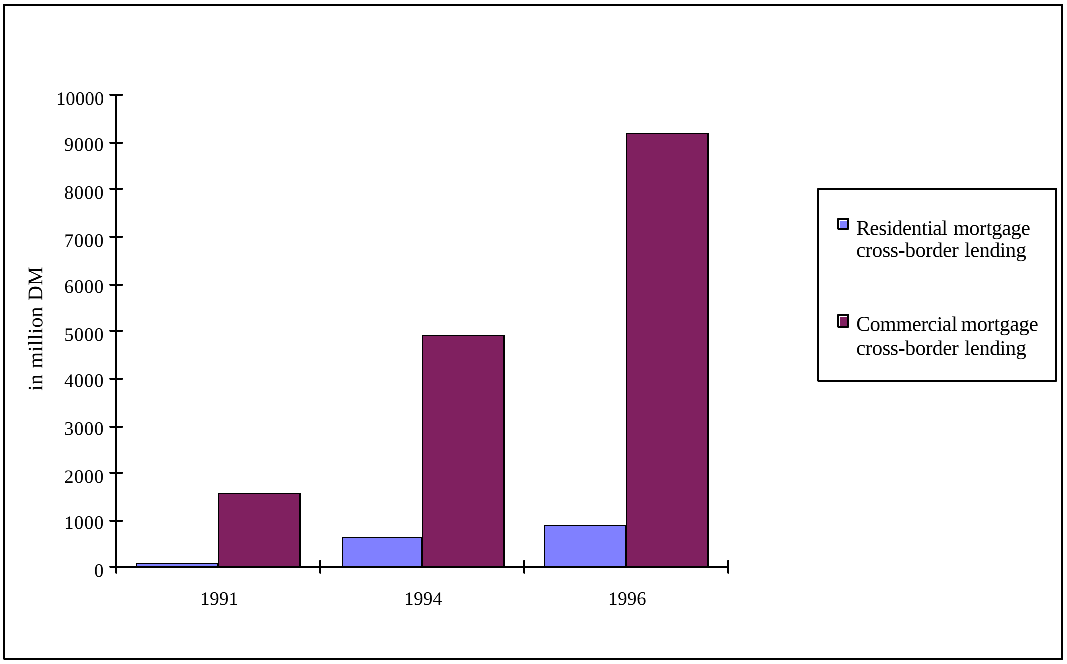
The EMF has recently commissioned a survey on the extent of cross border lending.[57] The results of the survey have not been released but the preliminary information is that there is no statistical information

56 The definition of intermediary can block their use by cross-border lenders. In France, intermediaries originating loans for such lenders may be considered to be operating branches which entails considerable cost, reporting and tax implications. Furthermore, if an intermediary is found to be in violation (i.e., not applying to operate a branch) all contracts will be considered null and void.

57 Confidential correspondence of August 1997. The survey analysis is not complete and the results have not been approved.

concerning cross-frontier activites under the freedom to provide services[58]. The lack of data appear to be related to the non-existence or near non-existence of this type of activity. The only country the team has obtained quantitative information on cross-border lending is Germany[59]

Figure II-11 German Mortgage Banks: Commercial and Residential Mortgage Cross-Border Lending



Source: Verband deutscher Hypothekenbanken, various annual reports.

Following this information, outstanding cross-border residential mortgage loans reached 908 million DM by end-1996, which made up for 0.27% of the total outstanding. The mortgage lenders are active in 12 European states (not Ireland, Finland, and Greece). The outstanding cross-border commercial mortgage loans in turn reached more than 10 times that level: 9,204 million DM; here cross-border lending made up for 5.39% of the total[60]. That is, compared to their relative importance, commercial cross-border lending accounts for a 20 times higher relative share, if compared to residential mortgage lending. Also, the growth rate of cross-border residential mortgage lending is lower than for commercial mortgage lending. Anecdotal evidence also suggests that cross-border non-real-estate consumer lending is more dynamic than cross-border residential mortgage lending.

58 Some statistics collected through the team's survey refer to foreign lender market shares in domestic markets, albeit in grossly varying definitions. These statistics do not directly relate to the definition of cross-border lending, they typically refer to foreign banks market shares in a domestic mortgage markets, either through subsidiaries, branches or cross-border lending.

59 UK lenders have been pioneers in cross-border lending. Contrary to the German mortgage banks, however, they have established subsidiaries or branches to conduct their business. As noted above the team does not view this as true cross border lending as competition takes plaece with the dominant local products using predominately locally generated funds.

60 For a Portuguese lender, the unpublished EMF survey cites a similar relation.

G. Assessment

The data presented in this chapter demonstrate the wide variety of mortgage lending, loans, lenders, and terms across the European Community. This variety has important implications for both consumer protection and cross-border lending.

Product Variety: Generally speaking, product variety is healthy for the consumer. More choice for consumers allows them to better tailor loans to their housing and economic needs and preferences. Product variety can represent an important vehicle for competition. A new lender can enter an established market through offering a new product not easily replicable by existing lenders (e.g., a lender with access to wholesale funding can enter a market dominated by depository institutions offering reviewable or variable rate mortgages by offering a fixed rate product). Such variety causes problems for consumers as well as mortgage instruments are complex and difficult to compare. *This underscores the need for standardized disclosure and cost comparison methodologies.* This issue will be addressed in the APRC and Code of Conduct discussion in the chapter III.

Consumer protection can affect the *product mix* in a country. The obvious example occurs with the regulatory or legislative requirement to offer a universal right or early repayment. This requirement eliminates a particular class of products and lenders that refinance their loans through the issuance of non-callable bonds. Other examples include limits on the magnitude of prepayment fees or on the rate adjustment of variable rate mortgages which can deter new lender entry. There is obviously a trade-off between the desire to protect consumers against interest rate risk and the desire to expand competition and product variety.

Consumer protection can affect *pricing* of mortgage credit within a country. In the UK for example, lenders compete aggressively on the basis of initial period discounts (i.e., a heavily discounted rate for the first 1-3 years). At the end of this period the loan becomes a normal reviewable rate mortgages. In countries with caps on annual rate increases or caps on prepayment penalties (which are necessary for the lender to recoup the discounted initial rate) the ability to offer such discounts is sharply reduced reducing the capability of lenders to enter a market competing on price alone.

Lender Variety: Variety in lenders can foster increased competition on price, service, and product. Such competition is healthy for the consumer as it tends to reduce margins on new loans to marginal cost levels (with a competitively determined profit margins). This solution is to be preferred to dominance by particular lenders with access to low cost funds, even if dedicated to housing. Such subsidies distort the market, encourage inefficiency and deter competition, both domestically and cross-border, to the detriment of consumers in the long run. As noted above, consumer protection, which primarily affects products but indirectly lenders, can in the end deter competitive entry.

Collateral Access: A major defining aspect of mortgage lending is its collateralized nature. Access to collateral in the event of default reduces the credit risk of housing lending, improves the marketability of securities backed by housing loans and facilitates more competition and less rationing of credit. Access to collateral varies markedly across the member states and is determined by national law that is not readily subject to European-wide harmonization. Nevertheless, it remains a significant barrier to cross border lending by both increasing the risk of new lenders entering the market and requiring a substantial physical presence in the country to manage and monitor the registration and foreclosure process.

Information Access: A key determinant of expanded markets is access to information. Access to borrower credit histories reduces the information cost of underwriting for lenders. Furthermore it facilitates risk-based pricing which can expand the market.

Reduction of Exchange Risk: The single currency will definitely remove a major obstacle to cross boarder transactions, which has overshadowed other aspects to a large extent. For the first time borrowers will be able to compare the prices of loans granted by banks in different countries without having to take into account the currency risk. Furthermore it is quite evident that cross-border information about products and prices is becoming easily available as modern forms of communication develop rapidly (e.g., the Internet). It can be expected that the concept of a Single Market will thus be realized to a particularly large extent in the area of financial services. For various reasons these effects are happening more quickly regarding savings and investment products, but loans will certainly follow. Importantly, increased competition for savings products will reduce domestic depository institution funding advantages improving the prospects for cross-border competitors.

Information Technology: Telephone and Internet banking and automated underwriting suggest that the advantages of branch based mortgage delivery systems will decline. The increased use of intermediaries (which dominate mortgage origination in Ireland, the Netherlands, the UK, and are significant in Germany) place a premium on standardized disclosure to deal with an expected proliferation of products and competitors.

Regulation: As the risk and cost of remote origination of mortgage loans falls, the importance of regulatory barriers to cross-border competition will rise in relative importance. Any attempts of regulators to block entry on the grounds that new products or lenders are operating in an unsafe or unsound manner for the consumer will become more apparent and subject to scrutiny. As consumers become more aware of product and lender diversity, pressure to expand the range of choice will also increase.

III. ISSUES IN REGULATING MORTGAGE LENDING

A. An Analytical Framework

Consumer protection in mortgage lending involves the classic trade-off between allowing as many consumer choices as possible, and at the same time protecting the consumer from those choices which might lead to an inequitable allocation between him and the lender. Economic theory has no blueprint for this intrinsically social choice.

It should be noted in this context that, being a social choice issue, the introduction of consumer protection regulation typically implies reducing the benefits, or utility, for some consumers and adding benefits for others. The view that additional consumer protection regulation unambigously increase the welfare of every single consumer, or even automatically of an aggregate measure of all consumers' welfare, must be dismissed. The corollary is that additional consumer protection rules do not per se reduce producer surplus („profits"), as suppliers adjust to different legal environments. The issue is therefore to seek for rules that maintain or expand aggregate welfare while reducing the potential for serious shortfalls of welfare for individual consumers. Clearly, in the field of mortgage lending there are regulations in some EU countries that function de facto as barriers to entry to the respective market, with the effect of enhancing welfare for few while reducing it (through absence of competition) for many.

Therefore, frequent indications of a "higher" or "lower" level of consumer protection fall fundamentally short of characterizing the matter of debate. Rather, social choice has to be made whether and where to restrict the choice of individual consumers, for larger benefits to be derived in the aggregate. In many cases, these cost-benefit judgements are rather straightforward (e.g., improved transparency or standardization (uniform calculation method for APR)), in most so-called „material" consumer protection issues, however, detail judgement of costs and benefits is needed (e.g., early repayment).

Table III-1 characterizes the benefits of a transposition of the Consumer Credit Directive as both tangible (a potential decrease in credit costs due to increased competition) and intangible (protection of consumers from unfair outcomes). These benefits may be potentially large, for instance if financial mobility of borrowers through higher product choice and lower prices could be achieved. The potential costs are a tangible increase in credit costs, for instance due to transaction costs of providing disclosure, and intangible costs in terms of regulation eliminating individual contracts or products not being offered and interference in the contractual freedom of consumers.

Table III-1 Tangible and Intangible Costs and Benefits from Transposing the Consumer Credit Directive to Mortgage Lending - A Stylized Structure

	Benefits	**Costs**
tangible	decrease in credit costs market expansion (nat'l & cross-border)	increase in credit costs credit rationing
intangible	protection of borrowers from potentially unfair market outcome borrower mobility	interference in contractual freedom less self-selection of borrowers elimination of products

As an introduction into the detail discussion below, we follow here for purely didactical purposes a standard approach of decomposing the mortgage interest rate into its individual loan (or contract) components. These can be seen as different goods provided by the same supplier, for a specific price (cost of credit). In particular, it is useful and common practice to deal with lender's or borrower's options as separate loan components. Such options, or in legal terminology rights, are laid down in the CCD. While we arrange the discussion here around the price/cost effects, for didactical and empirical reasons (costs are typically tangible, i.e., measurable), there is always a utility equivalent, and costs should not be seen in isolation.

To decompose the service components of a mortgage loan, consider the following formula reflecting periodic costs:

$i^m = i^{cf} + t^l + t^{nl} + (v^b - v^l)$, with

i^m: cost of mortgage credit,
i^{cf}: cost-of-funds,
t^l: internal (borrower-lender) transaction costs,
t^{nl}: external transaction costs (borrower-government or other),
v^b, v^l:: value of options and other rights traded between lender and borrower.

Periodic *cost of funds* (i^{cf}) reflect the costs of capital market and deposit funding incurred by the lender. They typically fall down in a risk-free capital market rate, a liquidity premium for the chosen debt instrument, and a credit risk premium reflecting the lender's default risk. The costs of funds are mainly determined by the lender's standing in and the development of the capital market, as well as the structure of his refinancing (retail vs. wholesale). They also depend on the degree of maturity transformation.

Consumer protection measures directly affect this loan component, for instance if a mismatch between costs of funds and compulsory index-linked adjustable rates are created. On the benefit side stands the utility derived for the consumer from transparency, equal treatment with other consumers, absence of costs of individual bargaining (or litigation), etc..

Internal transaction costs (t^l) between borrower and lender decompose into up-front costs, such as loan processing, collateral appraisal, structural survey and other handling fees, as well as operating costs of the loan. Typically both are priced differently, i.e., as up-front fees and margin. At the core of the APRC discussion (Directive 90/88/EEC) is the question of which cost elements to make compulsory to integrate.

Transparency and regularity of up-front costs that borrowers incur when taking up a loan are directly addressed by the Consumer Credit Directive: issues are disclosure and contract standardization requirements (APRC (Directive 90/88), and other disclosure duties (Article 4). In the case of mortgage lending these would obviously require modifications that will be discussed below.

Periodic operating costs are administration, monitoring, servicing. These elements can both directly (e.g., limitations on additional charges) and indirectly (e.g., through the relative quality of the loan recovery process with repercussions on monitoring costs) be affected by consumer protection measures. Again, this has to be seen against the potential benefits of doing the regulation.

Empirically, *external transaction costs* (t^{nl}), emerging between borrower and government, insurance companies, conveyancers, real estate appraisers, and other agents play a crucial role in determining access to mortgage credit. These elements are notoriously difficult to address by a credit directive, which focuses naturally on the lender-borrower relationship and here in particular on obligations of the lender.[61] As the potential of unfair outcome for the consumer in many of the contractual or legal relations with other agents is vast, a broader approach for consumer protection legislation would be required, but is difficult to realize[62].

A more relevant issue that can also not be addressed by the Consumer Credit Directive are consumer protection standards for compound products that the lender offers or individual elements of that product that he mediates, e.g., the combination of an insurance and a credit contract. Here the question arises how flexibly the ambit of a Directive can be formulated.

61 A typical example is the mortgage indemnity guarantee police which is widely compulsory in the British and Irish market. The typical conditions of these policies may lead to serious disadvantages for the borrower in the default case, but are nevertheless in neither country covered by corresponding mortgage lending legislation.

62 A rare example where external relations have been regulated in a code of conduct by the initiative of mortgage lenders are the British Standard Mortgage Instructions, which regulate the relations between solicitors/conveyancers and both lenders and borrowers.

Regardless of the applicability of the Directive to the specific external relationship, there is an ongoing discussion over requiring inclusion of external transaction cost elements into an APRC calculation (Directive 90/88/EEC), although so far only for consumer loans.

Of particular relevance is the *value of unilateral borrower options*, *the value of fixing the interest rate over a specified time period* (i.e., technically, a series of forward rate agreements between lender and borrower), *and interest rate caps/floors and other derivatives* (v^b) that create risks to be covered by the lenders. These add an insurance function to the financial intermediation operations of the lender that is reimbursed by the consumer through a risk premia. The consumer, in turn, receives both tangible and intangible benefits of having a universal option.

The few, but economically powerful, material consumer protection provisions embedded in the Consumer Credit Directive and the more extensive national material consumer protection regulations strongly affect the values of these loan components:

Default: Loan default can be interpreted as a unilateral put option of the borrower[63]. Loan foreclosure and recovery is addressed in the Consumer Credit Directive only indirectly through Article 7 (Repossession), largely irrelevant for mortgage lending. However, national consumer protection largely defines the ability of the lender to enforce the contract as well as the value of the loan default option (expected loss rate, loan recovery ratio). It is a major determinant of market penetration and development. Other borrower options, such as portability and assumability of mortgages are a subject of some national consumer legislations.

Rate Certainity: Fixing the interest-rate of a loan means incurring interest rate risk by lenders which are financed with variable rate deposits. Lenders either manage this risk by obtaining fixed rate finance on the capital market (through interest rates swaps or issuance of fixed rate debt) or absorb it through maturity transformation. In both cases, the consumer pays a risk premium, except for rare capital market situations (inverted yield curve). Consumer protection may directly affect a lender's ability to offer fixed rate finance, and therefore the premium the borrower needs to pay for rate certainty, for instance through prepayment regulations. Similarly affected are interest-rate caps and other interest-rate risk protection instruments extended to the borrower against a premium. Examples for consumer protection measures that directly affect the availability or price of rate certainty and protection are:

- *Prepayment:* The option to repay part or total of the loan balance before maturity can be interpreted as a call option of the borrower[64], for which a market price exists. Both the option and the

63 Through the collateral characteristics he may „sell" the underlying asset, the home to the lender. Since most European legal systems know the discharge model, transaction costs are largely calculable.

64 He repurchases the underlying asset, the mortgage loan in the balance of the lender, at nominal value.

requirement of an equitable reduction in cost is addressed in Article 8 of the Consumer Credit Directive. Regulation of the amount of reduction (prepayment penalties) in national legislations alter substantially the value of the option.

- *Loan offer period:* the borrower option to take or leave a loan offer that must be upheld for a legally specified time period affects the ability of the lender to offer fixed rate finance.

- *Rescission or cooling off/denial of loan take up:* the borrower option to withdraw from the contractual agreement unconditionally, or linked to the case that the underlying real contract or other financial contracts do not materialize, to deny to take up the loan. These options are not addressed in the Consumer Credit Directive, but in many national consumer protection laws.

There are also unilateral lender's options that the borrower underwrites (v^l), and accordingly reduce the cost of credit. Economically the borrower assures the lender certainty in a number of aspects. The most important examples for our discussion are:

- *Assignment:* the option for the lender to assign, or factor, a mortgage to another creditor with a minimum of transaction costs (Article 9) and without the consent of the borrower, leading to a benefit to the lender e.g., by exploiting the refinancing technique of securitization. This issue is addressed by British consumer protection standards.

- *Rate Change:* the option for the lender to change contract conditions unilaterally, e.g., in the case of a reviewable rate mortgage (not addressed in the Consumer Credit Directive). Numerous national legislations restrict this right, i.e., by demanding linkage to a reference index.

- *Rate Lock:* de jure in the case of exclusion of the prepayment option and de facto in the case of prohibitive formulation of prepayment penalties (related to Article 8), the borrower guarantees the lender a fixed interest income. This is the corollary to the prepayment option. Numerous national legislations restrict contractual freedom here.

A result of these considerations is that all individual components of a mortgage loan will be influenced - albeit to a differing extent - by national consumer protection regulations or, equivalently, regulations laid down in the Consumer Credit Directive. Clearly, any causality between benefits and costs on the one hand and regulation on the other hand found will be only partial, depending on the relative importance of other determinants, such as housing subsidy policy, competitive situation, tax, legal, and general economic environment detailed above. Also, the impact of consumer protection will diminish over time, again to a varying degree, as market agents do adjust to changes in legislation.

We will explore in this chapter what the economic costs and benefits of national legislations or, where transposed, the Consumer Credit Directive are for a selection of contract components. The discussion shall explore the limits where consumer protection would interfere with product diversity under today's financial sector technologies, and give guidance to concrete formulations of legislation, if desired. The order of the issues which are regulated in the Member States follows the logical sequence of a mortgage credit operation.

For all detail questions the reader is referred to the National Reports on consumer protection regulation (Part 2).

B. Pre-Contractual Phase

The precontractual phase is dominated by the creation of transparency over final contractual conditions. Given the fact that the borrower must expect to incur substantial transaction costs for changing the lender when the loan is current, whatever the conditions of early repayment are, a well-informed borrower choice is the most important protection against potential abuse in long-term financial contracts. Some observers[65] argue that information requirements embedded in consumer protection legislation are inferior in their regulatory power and therefore less relevant than “material“ consumer protection, such as protection in the case of prepayment or default. The study team contests the stipulation of such a hierarchy, particularly in the light of existing protective legislation on unfair contract terms and general private law regulations that protect both contract parties. In addition, for the typical consumer, rather than in cases of insolvency, improved access to information is certainly the key consumer protection measure.

1. Counseling Duties

a) Overview

Under the current provisions of the Consumer Credit Directive a consumer is provided with information about all the important aspects of the contract. The need to provide consumers with added protection by imposing on lenders an additional duty of advice has not been introduced in specific national legislation in the field of mortgage lending. However, there are interesting models based on case law and codes of conduct.

b) Models for Regulation and Conclusions

We find a certain standard level of protection based on two models. The first model is regulation in industrywide codes of conduct:

65 E.g., Alleyne/Reifner (1996)

- The Danish Code of Conduct provides that counseling shall be of high professional standard and shall consider the consumer's interests[66]:
  - Standard product may be sold w/o advice. Lender shall alert borrower of this fact.
  - If offered, advice shall be oriented at the products offered by the lender in the property category of the borrowers choice. Also, alternative ways of arranging the mortgage ban must be discussed.
  - Important assumptions and conclusions shall be fixed in writingf.
- The Dutch Code of Conduct does not oblige the lender to provide counseling except in the case of financial difficulties.
- The Mortgage Code issued by the Council of Mortgage Lenders in Britain, effective from July 1, 1997, presents particular original solutions. It establishes in Section 3 the right of the borrower to choose from up to three different levels of information/counseling service:
  - Advice and recommendation,
  - Information on the different types of mortgage products,
  - Information on a single mortgage product only.

The German situation stands for the second model, imposing counseling duties based on general principles requiring particular protection according to the specific circumstances of the case. According to German case law the credit institution is required to inform the consumer about risks if the borrower has no experience in lending practice, and/or if the bank proposes a rather unusual financing model while same financial service could have been achieved with a standard loan. [67]

The study team does not propose to have a directive requiring counseling duties beyond simple disclosure. This is because the existence and the extent of counseling duties depend on the individual circumstances of the case, particularly the duration and the intensity of the customer-bank relationship. Also, typical risks in mortgage lending (e.g., market risk) exist for both sides, a fact which can hardly be reduced or diminished by counseling duties of lenders.

One should also bear in mind that a large and growing number of borrowers do not rely on the lender's know-how but on their own or on other sources'. If mortgage lending as such would generally be linked with extensive counseling duties, smaller competitors with a low cost profile could be particularly affected. Market segments offering favorable conditions for "lean products" would be impaired and obstructed in their development. Negative effects were also imminent as regards cross border lending; foreign providers offering financially competitive products would be negatively affected by counseling duties referring to local peculiarities such as taxes etc. As a rule lenders are sufficiently motivated to act responsibly when granting loans as they are vitally interested in avoiding risk and loss; this is a major difference compared to security transactions where banks act only as intermediaries. This effect is

66 Art.5.2 of the Danish Code of Conduct

67 BGH, 4.12.1990, ZIP 1991, p.301; Köndgen (1994), p.49

enhanced by modern insolvency law rules granting borrowers that have acted honestly a discharge, i.e., shifting an important part of the credit risk to the lender.

As regards counseling the study team favors increasing transparency. The Danish and UK codes of conduct may serve as examples. Lenders should disclose in their loan offer whether a standard product is sold with or without advice and which level of counseling the customer may presume. This way counseling may become a special service offered by lenders which are liable to perform at a high professional standard according to the general rules of civil law.

2. Advertisement

a) Overview

The Consumer Credit Directive contains one obligation with regard to advertisements: the APRC must be included in any advertisement in which a rate of interest or any other figures relating to the cost of the credit are indicated at least by means of a representative example.

Member States have introduced specific rules in the field of mortgage lending. In most of the Member States we find the obligation to include the APRC in advertisement, namely in Austria (§ 35 II BWG), Belgium (Art 12 of the „Arrete royale“ 5.2.93), Denmark (Art 8 Mortgage Credit Act), France (Art.L. 312-4), Germany (§ 4 Price disclosure regulation), Ireland (Section 21 of CCA), the Netherlands (Art 3 of the Code of Conduct) and Spain (Art 3 of the Orden of 1994). However, there is no systematic approach to enforce product-specific information, or labelling, in order to facilitate interpretation.

Other specific rules are designed to prevent unfair advertising. In Denmark the use of incorrect and misleading advertisements which are meant to influence the consumer is prohibited and in Ireland the Director of Consumer Affairs oversees the form and the content of advertisements and may withdraw incorrect ones. It is interesting to note that in France it is illegal to compare repayments under loan with rents becoming due in the case of renting a dwelling[68].

b) Models for Regulation and Conclusions

Meaningful advertisement rules would have to ensure a meaningful combination of APRC and product information that ensures both correct interpretation of the price indications, and inter-product as well as

68 Art.L.312-6 of the Code de la Consommation

international comparability. We will show below that there are critical problems with the concept of APRC in this respect, as without detailed product/utility descriptions there is ample room for distortive comparisons to the detriment of the consumer. Advertisement rules should therefore be developed in combination with a European APRC concept. Product characteristic descriptions will have to focus on core characteristics of product, implying the elaboration of labels for sufficiently comparable products (see below).

C. Conclusion of the Contract

1. Form

Apart from the obligation that the contract must be in writing under Art. 4, the Directive does not require any standardization of consumer credit agreements. Most of the Member States provide that the credit contract must be in writing.

In Denmark mortgage lenders must make use of either the mortgage-deed-formula A or B (Pantebrev), which were approved by the Danish Ministry of Justice. The Irish Consumer Credit Act constitutes that an agreement for a housing loan shall contain on the front page a notice of important information. It is regulated in detail how the front page should look. The French rules lay down the obligation to send the mortgage offer by post in order to fix the exact date of the borrower's receiving the offer[69].

The study team finds that a written contract should be a mandatory condition.

2. Information Disclosure

Standardized access to information gains importance with three long-term trends:

- improved access to information and computation technology enhances the physical capacities of borrowers to gather and process product and cost information of ever more loan providers.
- with strengthening education levels, the intellectual information processing capacities of borrowers increase over time.
- with these two developments, products and package products become in turn more and more sophisticated, leaving the uneducated borrower or the borrower with limited access to information and computation technology in a worse position.

69 Art.L. 312-7 Code de la Consommation

a) Overview

The Directive contains a list of contractual terms which Member States may require to be included in the written agreement as being essential[70]. By transposing the Directive into national law the Member States have included all or some of the particulars referred to in the annex to the Directive.[71] In the field of mortgage lending specific rules concerning disclosure and transparency have been introduced into national legislations.

Most of the Member States have introduced provisions under which the offer must include the APRC, the number, the amount and the time of repayment installments. Lenders in some Member States are obliged to include the total amount of costs.[72] In Germany this provision no longer exists as Art.5 of the Consumer Credit Directive concerning the total amount of costs has been repealed. In France, Belgium, and the Netherlands the offer must include the period of validity. Some national legislations provide that all the essential contract conditions have to be disclosed, especially the conditions of adjustment, possible transfer, and interest rates in arrears.

Apart from the general obligation to inform the borrower, the Irish Consumer Credit Act provides that all the documents have to include warning notices, e.g., “Your home is at risk if you do not keep up payments on a mortgage or any other loan secured on it“, or in case of an agreement with adjustable rates, “The payment rates on this housing loan may be adjusted by the lender from time to time.“

Information disclosure has been at the heart of a variety of codes of conduct that are in force in a number of countries (e.g. the Netherlands, United Kingdom, Denmark, Italy). The details have been provided in the National Reports (Part 2).

b) Digression: The Code of Conduct Approach to Information and Counseling Requirements

The reviewed European Codes differ in significant ways with their own strengths and weaknesses. The UK Code is the most specific in the area of counseling duties.[73] This area was the major change from the draft Code announced in 1996 and the final Code launched in 1997. The UK Code is also the most comprehensive with respect to the product information requirements for lenders, perhaps reflecting the

70 Art. 4 III of the Consumer Credit Directive

71 Commission of the European Union (1995, p.51)

72 Austria (§ 33 II BWG), Denmark (Art.8 of the Mortgage Credit Act), France (Art.L.312-11)

wide variety of product types available in the UK. The UK Code is weakest when it comes to treatment of intermediaries. Although the Council of Mortgage Lenders is attempting to expand coverage to this important segment of the market (representing over 50% of recent originations) it is hampered by the lack of an organized trade body representing intermediaries.

The Dutch Code is strongest in its treatment of intermediaries, requiring lenders to request compliance from and exclude intermediaries who do not follow the Code of Conduct. The Dutch Code is far less specific on product information requirements than the UK Code.

The Danish Code also covers intermediaries but limits coverage to disclosure (importantly including the existence of remuneration). The Danish Code is strongest when it comes to product comparison information, requiring lenders to compare own products and provide information in a form facilitating easy comparison with products of other lenders. This comparison may be easier to accomplish in Denmark which is generally has a narrow range of product types.[74]

The Code of Conduct approach is relatively new. The Dutch Code is the oldest having been agreed upon in 1990. The Danish Code took effect in 1996 and the UK Code just recently in 1997.[75] The advantages of Codes of Conduct are that they are prepared by the industry, typically with consultation and input from government and consumer groups, with the result that they are more focused to the needs and practices of the industry and its customers. Another key advantage is flexibility. Markets and institutions can change much more rapidly than can legislation and regulation. Thus Codes tend to be more responsive to changing market conditions and products.

The disadvantages are the lack of statutory backing and enforcement (see National Consumer Council (1996) for the UK). Compliance must be adequately monitored with an independent and effective complaints and redress procedure:

- The British Code is monitored by *the Independent Review Body for the Banking and Mortgage Codes* comprised of representatives from the banks, building societies and independent consumers. The borrower is given contact information for this body as well as for the Offices of the Banking and Building Societies Ombudsmen and a Council of Mortgage Lenders Arbitration Scheme.

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73 The alternative is to allow for a market response in which loan counselors help consumers compare the offers and products of different lenders rather than require lenders to provide such counseling. A limitation of the market solution is the access to such counseling by lower income borrowers. A compromise solution would be to fund a neutral third party to provide counseling to such borrowers.

74 Almost all Danish mortgages are long-term fixed-rate instruments (see Chapter 3). Interestingly the bank must inform the borrower about the importance of making fixed price agreements which may suggest a bias towards such instruments.

75 The UK Code was first proposed in February 1996. After extensive comment from Consumer’s Groups it was revised and launched in March 1997 coming into full effect on July 1, 1997.

- The Dutch Code is enforced by a Supervisory Board selected by the council of Mortgage Lenders and confirmed by the President of the Court of Justice. The Board consists of lender and consumer representatives, most of who are recruited from the Banking consumer Complaint Board.

Also, the Code of Conduct approach is difficult to expand to cover all major credit providers, financial institutions and credit intermediaries. All three examples have different approaches:

- In Denmark, in the case of intermediary-originated loan, the bank must alert customers as to the nature of any partnerships and any special interest intermediaries (business partners) may have in the marketing of the bank's products, including whether the partner receives any direct or indirect remuneration from the bank, although not necessarily the amount of such remuneration. However, the bank will only be responsible for its business partners' compliance with the Code in cases where cooperation is based on a written agreement with the party concerned. In the event of dispute, borrowers have the right of complaint to the Consumers' Ombudsman or the Danish Mortgage Credit Appeal Board.

- In the Netherlands, the Code addresses intermediaries requiring the lender to:

  - Make every possible effort to encourage intermediaries to comply with the Code;
  - Send every intermediary that does not comply a written request to do so;
  - Exclude an intermediary from further mortgage credit business in the event of „profound failure" to comply with the Code.

- The National Consumer Council I the UK has suggested principles of Self Regulatory Scheme which are listed below[76]:

  - The scheme must be able to command public confidence.
  - There must be strong external involvement in the design and operation of the scheme.
  - As far as practical, the operation and control of the scheme should be separate from the institutions of the industry.
  - Consumers and other outsiders should be fully represented on governing bodies.
  - The scheme must be based on clear statements of principle and standards.
  - There must be clear accessible and well-publicized complaints procedures where breach of the Code is alleged.
  - There must be adequate and meaningful sanctions for non-observance.
  - The scheme must be monitored and updated in the light of changing expectations and circumstances.
  - There must be a degree of public accountability, such as an Annual Report.
  - The scheme must be well publicized, with maximum education and information directed at traders and consumers.
  - The scheme must have adequate resources but should be funded in such a way that the objectives are not jeopardized.
  - Independence is vital in any scheme that includes the resolution of trader/consumer disputes.

An assessment of the feasibility of a European Code of Conduct will be given below.

76 National Consumer Council (1986)

c) Models for Regulation and Conclusions

The starting point is the Annex of Directive 87/102/EEC in connection with Article 4 (3). If the Commission were to transpose the CCD or develop a new Mortgage Credit Directive, the team would suggest the following modifications of point 1:

- Description of good financed by the loan agreement: no transposition to mortgage lending.
- Amount of deposit, if any, amortization and payment plan: transposition to mortgage credit, where relevant.
- Entitlement of early repayment and reduction: transposition; to be amended by details on general conditions of prepayment (legal conditions), calculation method of prepayment penalties and all other costs associated with prepayment.
- Characterization of type of security: transposition, to be adjusted to mortgage lending conditions.
- Cooling off period, if any: transposition.
- Indication of insurance: transposition, to be included in additional information requirements.

Additional information requirements for mortgage lending (new point) should be formulated, following the approach for other loan types adopted in the Annex:

Ancillary services, which serve to support the underwriting, servicing or termination of the loan

- Information about freedom of choice of ancillary services.
- Information about financial conditions for ancillary services, if determined or commissioned by lender.
- In case of interest-only mortgages: warning about the necessity to maintain coverage of repayment capacity with an insurance or pension plan or other ancillary service.

Cost of Credit

- Advertisement: Minimum APRC (see discussion below) including national legally mandatory fees and costs of credit without optional features. Expected loan term and interest rate adjustment mechanism. Specification of major financial requirements to be fulfilled in order to obtain APRC (e.g., savings period).
- Individual APRC calculated on the basis of all mandatory and optional cost elements/loan features associated with the consumer's choice (possibly on single page sheet detailing all loan cost elements and description of features, see below).

Interest rate risk

- When ARM offered, information on the type of index used or historical performance of lender's rates if not tied to an external index. Info about conditions of internal and external refinancing of the loan (see below).

- Warning about riskiness of ARMs and an explanation and illustration of future potential repayments at the end of any temporary fixed, discounted or capped interest rate period; eventually a mandatory sensitivity analysis of the impact of a change in the nominal interest rate of +/- 1% point on the debt service could be required.

Debt service

- Monthly total costs of credit; includes amortization (APRC does not).

Default

- Warning about general consequences of default, including legal process.
- Warning about risk of losing equity or remaining with net debt position.
- Information about all additional costs incurred in case of default.

Other options

- Description of main borrower or lender options mandated by law or concluded in the credit agreement.
  - Specification of conditions for assumability (transfer to another borrower).
  - Specification of conditions for portability (transfer to another object).
  - Warning that the loan may be assigned to another lender.

Table III-2 Standardized Disclosure Term Sheet

Term	Product
Method of Repayment	Annuity, endowment, serial, balloon Frequency and timing of payments
Means of Repayment (endowment)	Insurance, pension (linkage; e.g., equity, fixed income)
Minimum APRC	Including national legally mandatory fees (list) and credit costs
Individual APRC	Including all mandatory and optional fees (list) and credit costs over consumer's time horizon
Monthly Total Costs of Credit	Including amortization
Rate Adjustment Method Index for Rate Adjustment	Fixed (term), variable; implications and illustration of effect of end of fixed discounted or capped interest rate period Identification, recent history
Conditions for Early Repayment	Whether allowed, limits on exclusion, possible penalties, notification requirements, possibilities for waiver
Condition of Default	How determined, consequences, potential fees and interest charges
Conditions of Assumability	If allowed
Conditions of Portability	If allowed
Possibility of Assignment	Notification responsibilities

The requirement that all lenders provide the above information on the loan contracts they offer would facilitate consumer shopping. The terms could be summarized on a 1-2 page standard format disclosure sheet with the different topics being presented in the same order for all products. A standardized disclosure (term) sheet could look like in Table III-2.

3. Annual Percentage Rate of Charge

a) Introduction

The importance of APRC as an instrument of consumer protection is reflected by Directive 90/88/EEC. The discussion has reached an advanced stage with second reading by the European Parliament[77]. The most important result of the process is agreement over the desirability of the calculation method, in particular the use of the equivalency method and of a standardized month as a basis for computation. However, core issues for APR discussions are only beginning to be discussed: in particular which the range of cost factors to be included into a calculation should be, to ensure comparability of the calculation results.

There has been a long discussion on the European level on whether to introduce the provisions of Directive 90/88/EEC into mortgage lending. Indeed, in an ideal world the APRC is at the core of consumer protection concerning the phase of contract conclusion. Increasing and standardizing the information presented to consumers about individual loan products would enhance the sovereignty of the consumer and the competitiveness of the market[78]. The presentation of a single, all-in cost enables consumers would make direct meaningful and undistortive comparisons and more readily “shop“ lenders and products.

The key assumption is that such a single variable can adequately describe the cost of a mortgage product and allow consumers to make informed choices. Unfortunately the use of a single cost measure is compromised by the nature of the loan product; a fortiori the mortgage loan product.

(1) Different Cost and Utility Components of A Mortgage Loan

The cost decomposition above shows that a mortgage loan includes a complex package of financial and non-financial services that are being provided by lenders, insurance companies, surveyors, conveyancors, government, and other agents. By rolling all of the costs into one variable, the consumer lacks information on the pricing of individual loan components, described in the basic equation above. Although often only compound products are offered, every cost component has its individual market value, that ideally the consumer should know in order to compare products.

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77 As of mid-November 1997.

78 Vorms (1993)

Also, no single service service supplier is able to calculate exactly the costs of the financial package. Most important, some of the loan components, the options and futures, require a detailed analysis of the utility the borrower can derive from acquiring them in order to render price comparisons meaningful. We will give examples below.

In theory, therefore, the consumer should be put into the position to judge the pricing of all major cost components *individually*. This approach is, however, practically infeasible. If looking at total costs, in turn, there is a danger that the APRC is used by certain suppliers to show a financial advantage where there is in reality none, by claiming comparability of the services provided that does in reality not apply!

Let us consider the following *example*: In the United Kingdom, external mortgage insurance is a customary part of a housing finance package (although some lenders self-insure), while in Germany it is not. Instead, there it is typically a differently priced Bauspar loan covering the second mortgage position.

However, neither excluding nor including mortgage insurance would render a German and a British ARM loan entirely comparable for the consumer, one would have to consider the entire package. To see this, consider two typical housing finance products: a 80% loan-to-value ARM loan combined with a Bauspar loan in Germany and a 80% loan-to-value endowment mortgage loan in the United Kingdom. In Germany, the Bauspar loan takes over the function of mortgage insurance, reducing the cost of credit for the first mortgage loan, letting it - in isolation - appear a bargain[79] In Britain, the concept of endowment mortgage without regular repayments, and also typically without a second mortgage, implies special protection through either external or internal mortgage insurance, which, following some commentators of the discussion, should be included into the APRC calculation, making the product appear expensive.

Obviously, only the entire package is financially comparable for the consumer, and this only under certain conditions (same loan-to-value ratio, same interest-rate fixing period and method, etc.), although both ARM products may feature very similar nominal interest rates, and also APRCs.

(2) Which Products Are Comparable, Which Not?

The difficulty is to define at which point products differ economically and where they are *sufficiently similar* to allow a meaningful and undistortive comparison. This theme is broader compared to the existing discussion about the in- or exclusion of cost components in the APRC calculation of a

79 As noted below use of the loan rate for the APRC in Bauspar loans significantly understates the true APRC as it does not include the opportunity costs of below market savings.

particular existing product (see Vorms (1993)). It is useful to consider the issues that arise with respect to APRC for some existing European housing finance products:

Adjustable Rate Mortgage: Calculation of APRCs for these loans, for longer than the short interest-binding period (3 months to under 1 year), would require a commonly accepted interest rate forecast, which is nonexistent. The universal approach in Europe has been to assume that interest rates remain constant; thus for purposes of calculating an APRC the ARM is treated as a fixed rate instrument, which suggests - wrongfully - a stability of rates for the consumers.

An APRC does not therefore provide an accurate comparison between fixed and variable rate loans but consumers should be made aware of the limitations of the calculation. In the U.S. there is language incorporated to highlight the potential variability of payments on variable rate loans. In the United Kingdom and Ireland, lenders must issue a warning concerning the variability of rates. In Spain, lenders must provide histories of different indices. Transparency, and education over structural differences of loan instruments, rather than exact calculation here serves the consumer.

Reviewable Rate Mortgage: If treated the same way as adjustable rate loans (assumption of rate to remain fixed), the same qualifications apply. An accurate APRC is not possible even under a commonly accepted interest rate forecast, as rates are adjusted at the discretion of the lender (e.g., Germany: Sparkassen, United Kingdom: building societies).

Endowment Mortgage: In an endowment mortgage, the borrower pays off interest to the lender and a monthly payment to an insurance company, which invests the funds. No principal is repaid until final maturity of the loan, when the sum invested pays off the capital amount of the mortgage. An insurance product (insuring the repayment of a sum invested) is coupled with a banking product (remuneration for the sum invested).

For APR calculation purposes, an assumption must be made about the performance of the insurance policy and the issue is comparability. It is not impossible, as Vorms (1993) conjectured, to do an APRC for such loan types; however, the utility of cost comparisons for the consumer is limited as he needs to balance costs and benefits of the individual components of the financial solution. Discussions in Britain and Ireland, where endowment mortgages still have a market share of 25-50%, show the difficulties in entangling insurance and banking product[80]. Another issue is freedom of choice of the provider of

80 A recent survey by the Consumer Association of Ireland revealed important defects that make comparisons difficult. Mandatory mortgage indemnity bonds, for instance, yield typical commissions for lenders of 20%; however most lenders refuse to indicate their commission.

insurance, a factor that would change any APRC indication as long as the ultimate choice of the borrower is unknown to the lender.

Ultimately, to be useful for comparisons the following alternatives would have to be compared: the APRC of an endowment loan relative to the alternative of an amortizing loan with an additional risk premium paid to the lender due to the lack of insurance, which will be mitigated by the fact that repayments are made. Differences in repayment speeds between the two alternatives have actually led Irish consumer associations to demand use of periodic costs per 1,000 £ in addition to APR. It is difficult to see how this service could be delivered with reliability for the consumer by a particular lender. The issue here is again transparency over cost elements and required ancillary products.

Bauspar Loans: Conceptually an APRC for German Bauspar loans should at least account for three elements of the contract: i) the savings phase, ii) the waiting period between "maturity" of the contract and loan allottment, and iii) the loan phase. Bauspar loans can only be extended at below-market rates, because they are funded by prior below-market rate savings, which creates an opportunity cost to the saver, and the lender has additional degrees of freedom for asset-liability management. A focus only on the loan rate clearly distorts the assessment of the true cost of the loan to the consumer. Additional inclusion of the waiting period would finally require a consensual forecast model on future allottments, which are prohibited by German law. [81]

However, including below-market savings and estimated waiting periods, and comparing with mortgage loans would be wrong as well, as the Bauspar contract delivers additional services to the consumer. These are i) the loan guarantee, ii) the option on getting the loan for a fixed rate (a complex European interest-rate call option with uncertain exercise time as a result of the waiting period).[82] As a result, an APRC formulation yields one of two paradoxical situations:

- if the savings period is excluded from the APRC calculation, Bausparkassen will boost their business by emphasizing the low nominal coupon rates their loans offer. Mortgage lenders and other competitors will, rightly, oppose this type of calculation as an unfair comparison.

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81 There are models for estimating the cost of a Bauspar loan. Lea and Renaud (1995) calculate an internal rate of return incorporating assumed opportunity cost of savings (Bauspar rate relative to weighted average of three different savings contracts reported by the Bundesbank) and the cost of the loan. Their model also takes into account the uncertain time at which the loan will be funded by calculating the IRR for different waiting periods. However, their and other models rely on working with ad-hoc assumptions that cannot be transferred easily into a commonly accepted APRC standard.

82 Making the borrower subject to a „waiting period" a unilateral option of the lender, which may lead to considerable additional financial costs to the borrower in the form of market based „interim finance" that would have to be included into an APRC calculation. Adjusting the period between „maturity" of the Bauspar contract (first right of loan take-out) and the actual allottment of funds will be a function of the amount of new savings the lender records, his reserve holding and investment considerations, as well as supervisory requirements. Supervision acts partly in favour of the consumer in that it enforces the use of interest proceeds from investment of reserves for smoothing waiting periods. However, the outcome is hard to assess for the purpose of APRC calculat ions.

- if the savings period is in turn included into the APRC calculation, the loan costs could be significantly higher than the costs of a comparable duration mortgage contract, leaving the subsidy question aside for the moment (this calculation cannot be made in practice, as in the ex-ante situation one would have to find a future mortgage contract beginning after the savings period), over the same duration. The Bauspar institutions would, again correctly, oppose in turn this type of calculation, as the benefit of the interest-rate option that the consumer acquires is not accounted for.

Things are again entirely different in the French épargne-logement case, where both savings and loan rates are not fixed in advance.

Box 4 The Potential for Misinterpretation of APRC due to the Possibility of Mortgage Prepayment

The APRC concept is based on the assumption that all loans run to term whereas in many European countries a significant proportion of loans prepay before maturity. A more accurate measure would allow borrowers to compare similar loans over their time horizon, or over a range of horizons, that reflect the fact that there is a non-negative likelihood that they prepay the loan. This approach is analytically preferable because the full term APRC assumption can give erroneous results for borrowers with shorter time horizons, in the US case practically all borrowers. For example we compare 2 fixed rate (FRM) and 2 adjustable rate (ARM) mortgages. The two FRMs have different combinations of rate and points (prepaid interest/fees). The 2 ARMs have different combinations of initial (discounted) and fully indexed (index + margin or FIR) rate. The better deal to the borrower is shown in bold.

Table III-3 Different Time Horizons of Borrowers and APRC

	Loan conditions	APRC based on 5 years expected duration	APRC based on full term (30 years)
30 Year FRM			
	7.375%, 4.25 points	8.45%	**7.82%**
	8.25%, 0.125 points	**8.28%**	8.36%
30 Year ARM			
	9.3% for 3 years, fully indexed rate 7.25%	8.91%	**7.95%**
	7.55% for 5 years, fully indexed rate 8.22%	**7.97%**	8.12%

Source: GHR Systems; Note: US example. Points denote discounts from par disbursement (e.g. 100%-4.25%=95.75% disbursement).

It is clear that if the borrower with the 5 year time horizon is guided by the APRC, he will select the wrong FRM and the wrong ARM, if the APRC would be based on the full term. Thus the assumption that the loan goes to term distorts comparisons and misleads the consumer.

Fixed-rate mortgages with and without prepayment option: With the same argument as in the case of Bausparkassen, it is difficult to compare fixed-rate mortgages with and without prepayment options, unless the borrower calculates the value of the option (which is dependent on his opportunity costs). Choosing on the basis of the APRCs of both loan types alone, without valuing the option, means deciding merely on the price, but not on the utility of either alternative. Box 4 shows the importance of calculating the APRC over the time horizon of the borrower instead of the full term, taking into account possibility of prepayment.

The conclusion derived from this non-exhaustive list of examples is that an APRC comparison between loan instruments without describing in detail their element character in a financing package, as well as their intrinsic characteristics may prove useless, if not potentially harmful to consumers' interests. It may indeed open the doors to unfair competition. APRCs on mortgage loans are only useful to compare within loan types or classes that have widely common characteristics, and therefore represent fairly homogeneous product classes. Furthermore, as the calculation example shows, other things being equal differing preferences of consumers change the optimal choice.

Given the present stage of European mortgage markets, with fundamentally different loan contracts dominating individual markets, comparisons in cross-border lending will necessarily, and incorrectly, be made between loan types. There is clearly a danger of stigmatization of certain loan types, if their benefits cannot be calculated as easily as their costs.

(3) Calculation Methods and other Technical Issues

The equivalency method for the calculation of the APRC laid down in Directive 90/88, as opposed to the proportional method, is widely acceptable to mortgage lenders. For the consumer it improves the information situation as it reflects more accurately the cost of credit. Additional calculation standards should be considered as well, for instance a measure on total periodic costs per unit of credit which will reflect the repayment profile that is particularly important in mortgage credit.

The problems that have been cited by various banking groups against the establishment of a mandatory daily exact calculation seem to have been removed by recent action of the European Parliament and endorsement by the Council. Calculating with a standardized month, as proposed, ensures better mathematical comparability.

The Parliament has also ended the discussion on a *logo*. The study team strongly feels, however, that for the case of mortgage lending this type of discussion is much more relevant in the form of "labelling" different financial products.

The question of whether APRC should feature one or two decimal places should be solved pragmatically by allowing the use of one decimal place. The small inaccuracy has to be seen against the background of the size of options and futures, as well as the impact of transaction costs, in mortgage lending.

b) Overview

Most of the Member States are protecting the consumer by the obligation that the lender must use an officially determined APRC method. The exceptions are Greece, Portugal, and Luxemburg.

However, this does not enable the consumer to compare directly the mortgage products in Europe, because each national legislation has determined differently which cost components of a mortgage loan have to be included in the calculation of the APRC (see National Reports and cases reported below).

Given the problems described it is furthermore unsurprising that APRC is a source of constant public debate in countries where its use is mandatory for mortgage lending. APRC-related problems are widely seen by lenders as a key problem introduced by consumer protection legislation; also - while endorsing the principle - many consumer associations are not content with the practice. For a legal overview concerning consumer credit we refer to the Report on the Operation of the Directive 90/88. The following empirical observations have been made with introducing the APRC for mortgage lending:

- In Sweden, lenders have to publish the APRC with two decimal places and under the equivalency method. The banking association regards it as potentially distortive and states that consumers typically solely look at the nominal rate. While the Consumer Credit Act demands the inclusion of mandatory costs, understanding differs strongly between consumer protection representatives and lenders as to what to include, and how to define, the term “mandatory“. Existing APRC formulations are the result of industry or lender-specific business practices. The law shifted the practical problems to daily business practice by remaining vague. The lowest denominator arrived at ultimately was to include fire insurance as an element that is required by law. There is also no requirement for the indication of its elements once an APRC has been stated, except ultimately when the contract is closed.

- In Ireland, which has also transposed the Consumer Credit Directive to mortgage lending, the limitations are stressed by interview partners, particularly with respect to loan-insurance packages. Emphasis by lenders is made to express APRC over whole period cost (blending discount and “true“ rate). No other rates than APRC can be shown in advertisements; however according to specialist press reports consumers still show higher interest in nominal rates. Concerning the risks involved in the predominant adjustable rate finance, Ireland requires lenders to warn the consumer with the APRC disclosure that underlying rates are variable; the impact of change of 1% in rate on monthly payments has to be demonstrated to the consumer.

- In Germany, APRC calculations apply to mortgage lending, hitherto under the national calculation method, subject to the Price Ordinance (Preisangabenverordnung). Germany excludes all five derogation items from Art 1a (2) Directive 90/88, reducing the APRC content to the direct cost of the specific mortgage lending activity as well as insurances demanded by the lender for obtaining the loan. Lenders make particular emphasis on not including external transaction costs, in particular government charges.

- In Spain, APRC calculation includes all costs, if mandatory. At issue between lender and consumer groups has been the introduction of new fees by banks outside the legal APRC definition, leading to less comprehensive and comparable indications. Introduction is generally viewed as positive as it has led to a standardized calculation formula. Before transposition, individual states within Spain had their own definitions and formulas. Limitation of the formula with adjustable rate mortgages are recognized through the requirement of inclusion of last 2 years of performance of the chosen indices. Lenders are required to extend an explanatory booklet to applicants. Lenders report, however, problems with the indication of the total costs of credit.

- The United Kingdom is the country with the longest tradition of APRC calculation. Lenders here complain about the potential for abuse opened by imperfect definitions of the way APRCs are calculated. For example, some lenders have used an initial rate as low as 1% for purposes of calculating the APRC. This was upheld in one court decision and struck down in another, creating ambiguity for both borrowers and lenders. This refers in particular to individual lenders that market their discount rates aggressively, by stating them in the APRC. Distortions of competition have increased over time; resulting in warnings by the Council of Mortgage Lenders against the abuse of the APRC.

From these cases it appears that domestic lenders have largely adjusted to calculate the APRC under domestic requirements for whatever cost elements they have to include. This is unsurprising as they had opportunities to influence respective law-making, which devolved - concerning the cost components - so far on the national level only. However, significant problems are reported that reflect conceptual difficulties in the case of mortgage lending. The concept may become easily extremely compromised in the eyes of both lenders and consumers. This stems from both uncertainty over the set of factors being included - laws the team has seen are notoriously unclear concerning the definition of mandatory cost elements -, as well as from potential for abuse.

Also, significant problems for foreign lenders are reported. An example is France, where even cost estimates on external services have to be given by the lender, which is often in practice impossible or only possible with an estimate.

c) Models for Regulation and Conclusions

In the field of mortgage lending, additional benefits for consumers vis-a-vis the status quo can be derived from employing a uniform calculation method, regulated on the European level, for determining the APRC for any actual combination of financial elements that is chosen in housing finance. The team considers the present status of the discussion about Directive 90/88 as encouraging. For pure calculation purposes, the finding is that there is no reason not to adopt the proposed method for consumer loans.

However, the core target of APRC, to create transparency and comparability of different loan offers, cannot be reached unless an understanding is reached which costs and utility elements are truly comparable, and hence should be included in a calculation. At the present time, such an understanding can even not be reached for elements that are widely vie wed as legally or industrywide "mandatory"[83].

The team strongly suggests therefore to abstain from a *European uniform definition of cost elements* to be included into an APRC calculation, unless a concentration only on costs that are directly caused by the lender, and independent of the national legal system, is desired (mainly cost-of-funds, see decomposition above). National legislators should instead be called upon to define sets of cost elements that are truly legally mandatory for all mortgage transactions in the country (e.g., legally mandatory insurances, taxes, and public fees) as well as those costs that are caused directly and invariantly by the lender[84], as a national "minimum APRC" calculation. If a mandated service or product (e.g., insurance) is offered on a competitive basis, the lender should be required only to include an estimate of the cost as it is impractical to require the indication of actual costs prior to giving a firm APRC estimate. Not legally mandatory elements would have to be excluded, as there are potential distortions, if comparisons to offers of foreign lenders are made (e.g., industry-wide mandatory elements such as insurance, etc.).

As long as legally mandatory cost elements differ greatly between countries, APRC calculations will have to vary. This would require the lender to change APRC calculation by the national market he serves; however, the domestic consumer would screen loan offers based on equal conditions.

For the team it is an entirely different concept to employ an APRC calculation standard to capture the total costs of credit a consumer incurs, given his particular choice of housing finance. Here, EU should only set uniform calculation standards; it may require the lender to provide the consumer with an APRC that includes the complete set of loan elements he chooses, subject to the limitations of Art 1a (2) Directive 90/88. A national minimum APRC, which ensures comparability on a minimum standard, and individual APRC calculations based on consumer choice would have to coexist[85].

With a varying base of the APRC calculation, whether between national definitions, or between the minimum and the consumer's product choice (total costs), it is necessary to link all public uses, especially for advertisement, to minimum information requirements specifying the advertised product characteristics. This could be implemented in the form of requiring the one-page standard disclosure form (see above) or respectively minimum advertisement supplementary information. If a nationally

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83 In the interviews made by the team, it became clear that there is seldom a uniform definition of the term „mandatory". The term may describe a legal requirement, a requirement by business practice, or a requirement in an individual contract. It is intrinsically unfocussed.

84 Mostly credit processing and intermediation costs.

85 It is the strong impression of the study team that the discussion on the Directive 90/88 disregards the central trade-off between comparability on one hand and completeness of information on the other hand. Without making all cost elements truly comparable across EU Member States, it is not possible to achieve completeness and comparability at the same time.

defined "minimum APRC" is used for advertisement purposes, the following minimum additional information should be required:

- Indication of contractual loan duration and rate adjustment mechanism.
- Indication of key mandatory and financially relevant conditions to be met for obtaining the indicated loan conditions (loan-to-value ratio, savings or deposit requirements, loan waiting periods, minimum loan volume, loan disagios).

For any individual APRC computation upon request of the consumer, in addition a complete list of fees and costs of ancillary services that are represented in the APRC should be required (see information and disclosure). Also, the borrower must be informed which cost elements the lender guarantees under the loan offer, and which not.

All APRC indications should be confined to *permanent* characteristics of elements or the entirety of the loan offer. This refers in particular to the use of intial (temporary) discounts as basis for calculating APRC, such as reported from the UK and Ireland. Such a provision is still missing in Directive 90/88.

A feasible mid-term strategy for the Commission would be to give consumer and banking associations the opportunity to develop classifications of mortgage products that are sufficiently "close" to each other concerning the utility the borrower derives, and define cost inclusion standards for these product groups. Examples are: contract saving loans, endowment loans, standard fixed rate mortgage loans, with and without prepayment option, standard adjustable rate loans, and endowment loans.

4. Loan Offer and Cooling-Off Periods

a) Overview

Loan Offer Period: An extended length of loan offer periods may render both maintaining fixed rate offers and disclosing a legally binding APRC problematic. In particular a loan rate commitment is a valuable option to the borrower, as it enables him to shop lenders. A lender's strategies include declining to fix the loan rate (by letting the rate float until loan closing) or to charge a fee for the rate committment (i.e., commit to a set rate in advance and take the risk). If a fee is charged it would be included in the APRC calculation.

Cooling-off period: Another unilateral borrower option is established by a cooling-off period after contract underwriting. In the surveyed countries, the borrower typically is entitled to revoke a consumer loan contract for up to 10 days after signing.

The cooling-off period or the period for reflection has become a classical feature of consumer protection law, under which the consumer may withdraw from a hasty engagement and reverse a decision taken in circumstances in which the creditor's pressure selling techniques or blandishments undermine the consumer's free and enlightened consent[86]. The Directive does not contain any provision allowing a consumer to back out of a credit agreement. Nor does it provide for a time limit between signature of the credit offer and signature agreement.

In the field of mortgage lending all Member States have refrained from explicitly introducing a cooling-off-period with view to problems that would be created for the refinancing side; however there are in some countries extended loan offer periods (Greece, France, Spain):

- In France the consumer is protected by a period of reflection which means that the consumer is not allowed to accept the offer of the contract before ten days have elapsed[87].
- Spain: A major element of the 1994 legislation is the requirement for the bank to give the borrower a binding offer good for 10 days. The borrower can effectively use the period to shop for better conditions..
- The British consumer protection system (CCA) contains a special withdrawal procedure for regulated contracts secured by land mortgages. Before sending the mortgage documents to the consumer for execution, the creditor is required to send him a copy of the unexecuted agreement which contains a notice in the prescribed form indicating the right of the consumer to withdraw from the prospective agreement. This provision has the effect of giving the consumer a cooling-off-period[88].

Loan offer and cooling off periods may not easily be transferred to mortgage lending, particularly in countries with strong wholesale refinancing. The main concern of mortgage lenders is interest-rate risk, as refinancing conditions might change at short notic e, and the question of compensation. In one case there are structural impediments:

- In Denmark, the key argument of mortgage lenders against cooling-off periods is the legal structure of lending. If the loan is directly backed by a bond issuance, cooling-off would mean in the revocation case that the loan would have to be called or delivered immediately after issuance. This would be also the case if the borrower would only want a downward adjustment in interest rates within the contract, because in the Danish bond construction downward adjustment implies calling the mortgage bond in case of internal refinancing.

Furthermore there are problems with non-interest costs that the lender incurs before and after underwriting. Reclaim of valuation fees are a debated issue in the United Kingdom and Ireland. Also, in Germany compensation payments payable to the lender for not taking up the loan are practiced.

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86 Report on the operation of Directive 87/102/EEC, Commission of the European Communities, 11.5.1995, COM 95, 11-final, p.76

87 Art.L.312-10 Code de la Consommation

b) Models for Regulation and Conclusions

In consumer lending, with its limited loan amounts and durations, loan offer and cooling-off periods invoke costs of the guarantee of a limited amount of liquidity, a problem that most lenders are able to solve by short-term liquidity management. In the case of mortgage lending, the sum of loan offer periods and cooling off periods may cause sizeable interest rate risk, and the arrangement of funding may be only very costly to revoke. Potential solutions to this problem are:

- The lender can handle a cooling-off period by giving the borrower an estimate based on current rates and then a final calculation based on the actual funding. The borrower is given an APRC based on the cost at the time the loan offer is made (case of loan offer period) or the loan documents are signed (case of cooling off period). If the rate changes during the commitment period a new, final disclosure is made based on the actual rate (which they have agreed to by not rescinding the contract). This mechanism would eliminate any positive value of the option to the borrower derived from potential interest rate changes, while keeping the principal notion of rescission for non-financial motives (e.g., rash action) intact.

- Rescission could be treated as a case of early repayment, making a prepayment penalty applicable. It is however likely that remaining durations are high enough to render such a penalty, even in case of only slight interest-rate declines, prohibitive for the consumer to exercise revocation. The same argument applies to the alternative of acquiring hedges on the market for derivatives to cover the risk, with a subsequent charge to the borrower. The Danish problem is less straightforward to solve. If the loan borrower becomes de-facto a bond issuer, today's solutions for revocation would be only the (potentially costly) call of the bond or the postponement of the issuance[89]. In the German case where the bonds are backed by a pool of mortgages a collateral substitution can be allowed.

- With the potential high costs of rescission, borrowers could be entitled to explicitly waive their revocation rights, against lower fees and/or rates. This would be a rather safe procedure in cases when contracts are attested by a notary or arranged by conveyancors (e.g., United Kingdom).

The list shows that a universal option of the borrower for rate constancy during extended loan offer and/or cooling off periods without the potential for the lender to charge compensation would create substantial problems in the case of at least one European mortgage product (Denmark), and be difficult to handle in the case of others. Making meaningful periods compulsory would mean that lenders would have to be allowed to charge a committment fee, or change the rate in case of changing refinancing conditions.

Allowing for these hedges, most accurately within nationally defined limits, would clarify that the core idea of leaving the borrower time for rescission is to give him room for renouncing the entire deal, not

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88 Section 58 of the Consumer Credit Act 1974 in the UK, Ellinger&.Lomnicka (1994, p.660)

89 It is interesting to note here that the Danish mortgage lenders are not entitled to charge compensation for foregone administration (servicing) costs over the remaining lifetime of the bond, hence there would be no compensation for foregone profits.

taking advantage of interest-rate changes. The study team suggests to abstain from a European regulation in this field.

5. Other Rules Putting at Stake the Finality of Contracts

French law knows a remarkable interdependence between the financed and the financing contract (see national report for details). This link has the remarkable consequence, that the financing contract is considered void if the principal contract fails within the period of one month.[90] The same is true as regards a plurality of financing contracts. It is evident that the French concept puts at stake the finality of contracts to a large extent.

Belgium may serve as a counter example where there is no legal link between the promise to buy and the loan contract intended to finance the purchase, but where buyers insist on adding the suspensive condition of obtaining the loan[91].

The French example shows that creating links between loans and the financed contract or construction contracts and among loans causes substantial problems. The question arises how to define that another contract has “failed“. Any deficiency in that respect may result in an option of the borrower to avoid the finality of the loan contract at his discretion. The economic arguments here are similar to the case of the cooling-off periods. There is also a considerable risk of costly litigation involving difficulties of proof. On the other hand borrowers may include clauses linking the respective contracts if there is a need for this in the individual case.

The study team would therefore not go any farther than providing for a duty of the lender to disclose to the borrower that the loan contract is valid and must be performed even if the financed contract or another necessary financing fails.

90 Art.L.312-16 of the Code de la Consommation

91 European Community Mortgage Federation (1992, p.25)

D. Execution of the Contract

1. Linked Contracts

a) Overview

Art. 11 of the Consumer Credit Directive establishes a link between the credit agreement and the sales agreement in the sense of granting the borrower defenses based on the financed contract.

In general, as regards mortgage lending the Member States have not introduced rules with respect to a link between the credit contract and the financed contract, e.g., a contract related to the sale of a house. France knows a minor exception regarding construction contracts where litigation can be suspended. As the German example shows, however, similar protection is provided under case law if lenders are acting outside their role of merely giving credit.

Beyond the Directive linked contracts are relevant as regards the finality of financing agreements. In this context the legal situation in France is quite remarkable (see national report).

b) Models for Regulation and Conclusions

The regulation existing with regard to consumer credit is mainly based on the fact that the consumer's rights are seen according to the model of a sales contract with deferred payment. Historically, the intervention of a third party financing the sales transaction was an innovation when sellers were no longer able to fund deferred payments. The borderline between financing the seller or the buyer, however, may not be very clear and the buyer typically is at risk to misinterpret the situation and underestimate the risks of separate financing (being obliged to repay the loan without regard of problems arising in the sales transaction). Buyers therefore were protected in the sense of being able to hold their defenses from the sales contract against the financing institution when the sale and the financing transaction did not clearly appear as two separate transactions.

As far as typical mortgage lending is concerned, the situation is quite different. Historically, sales of real estate have not been seller financed. The intervention of a financing third party has always been typical. In general, all parties concerned should be fully aware that the financing transaction has to be seen as separate from the sales contract. Consequently the study team does not see the need for specific regulation in this respect. Exceptions where buyers are misled or where the financing party is closely linked with the seller or practically identical do not justify regulation in a Directive and should be handled according to the applicable national rules.

2. Adjustment of Interest Rates and Other Financial Contract Conditions

a) Overview

The question of adjustment of financial conditions over time is not covered by the Consumer Credit Directive. The reason may be the explicit focus on short-term consumer loans with typically fixed interest rates. The regulatory practice is extremely diverse:

Member States, in general, insist on balanced adjustment clauses using different legal models. Most of the Member States provide that the conditions for the adjustment have to be explained in the loan contract, making it a question of disclosure to the consumer. Furthermore, adjustment mechanisms shall follow “objective“ criteria, or similar formulations that often create problems of interpretation (e.g., Austria, Sweden). Two Member States ban further contract adjustments altogether, but leave an option for contractual agreement on the adjustment of interest rates (Belgium, Greece). In Italy, a specially approved contract clause is required.

Only two of the 15 surveyed countries make the use of an index compulsory: Spain and Belgium.

- The Bank of Spain is entitled to recommend reference interest rates which must be applied to ARM.
- In Belgium, the law provides that an adjustment must refer to an index presented by the Council of Ministers. Belgium even bans further contract adjustments.

Beyond this, some Member States do further detail the indexation benchmark, *if* indexation is chosen as adjustment mechanism (France, Finland, Portugal, Sweden).

Typically, no additional charges may be exerted over what is stated in the contract (an exception is Denmark, where the lenders can change administration fees over time).

A fairly typical example for the difficulties in regulating the issue is Sweden. The Swedish Consumer Act does not make the use of an index mandatory, although it specifies conditions in case such a solution is chosen. Section 11 of the Act requires very generally the specification of the "conditions of amendment" in the contract, and bans amendments “to the disadvantage of the customer" in case of rate increases, without however specifying the recently more important case of rate declines. The lender may bring forward "increased loan costs or other increase in costs" to motivate rent increases, however measured. Interval ("fixed rate") financing contracts are exempt. If an index is used, it "may be amended in certain ways related to changes in a base interest on which the creditor has no significant influence". Again the lender has possibilities of derogation even from the index he chose; at the same time this shall "not be less advantageous to the consumer than to the creditor". Following the bankers' association, the majority of lenders do not link their adjustable interest rates to an index; i.e., use a reviewable rate mortgage.

The economic difficulties arising with reviewable rates may be illustrated for the case of Germany. This specification is here predominant for adjustable rate contracts, although indexed contracts are in principle allowed. In a recent survey, Verbraucherzentrale Hamburg in conjunction with IFF (Schmid-Burgk/Tiffe (1997)) analyzed 38 reviewable rate mortgage loans. The loans had an average value of DM 400,000 and average duration of 6.25 years. Key results of the survey were:

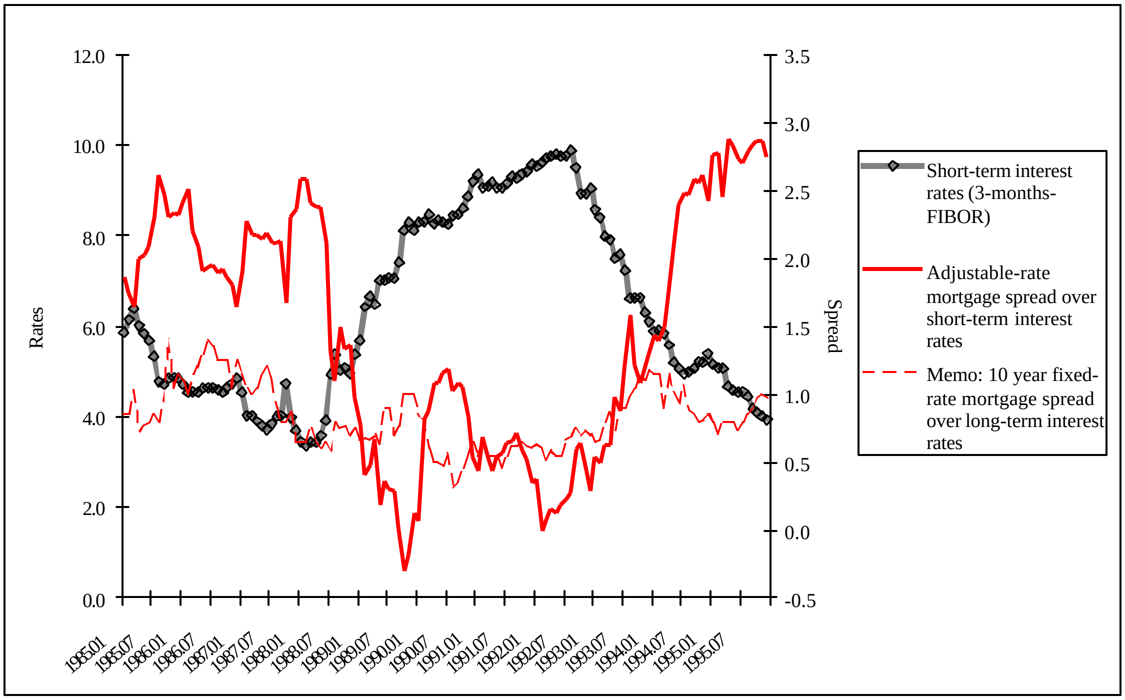
- There is indication that lenders use transaction costs of prepayment and external refinancing to increase the spread of ARMs over time. While the average underwriting nominal interest rate was -0.06% below the average interest rate published by the Bundesbank, at final redemption of loans the average spread was 0.95%, i.e., a growth of 1% over the lifetime of the loans. This change hints to price setting potential by the lender for seasoned loans.

- Downward adjustment of rates was recorded as sluggish, if compared to general rate indices. For 85% of loans, significant underadjustments were recorded. On average an overcharging of 590 DM per 100,000 DM loan volume per annum was calculated by the authors (i.e., .6%).[92]

- Adjustment practice and goodwill behaviour of lenders in cases of borrower complaints was recorded to be very variable; partially rate adjustment methods differed for different loans with the same lender (in one case for different loans of one customer).

92 This contrasts with findings of Diamond and Lea (1992) which found relative stability of ARM spreads over cost-of-funds for the UK, and at least temporary stability for Germany.

Figure III-1 Spreads of Average Adjustable rate Mortgage Rates Charged by German Savings Banks Over Short-term Interest Rates



Source: OECD, Deutscher Sparkassen- und Giroverband, authors' calculations.

Figure III-1 demonstrates the sluggishness in adjustment of adjustable rate mortgage rates charged by German savings banks to a fall in short-term interest rates. In both periods of interest rate decline since 1985, spreads over FIBOR widened significantly in relation to the spreads for long-term fixed rate mortgages. The latter are fairly constant, as long-term fixed rate bond refinancing conditions are passed through to the consumer; they reflect mainly operating costs, risks, and net margin. A comparison with deposit rates on savings accounts with 3 months notice, historically a predominant source of funds for German savings banks, yields even much higher, but less volatile, spreads.

Most lenders interviewed by the Verbraucherzentrale Hamburg argued that lags in adjustments were allowed "within a certain range". Interest rate adjustment mechanisms are typically not explicitly stated in the contract, nor mostly internally defined by the lenders. Court rulings are numerous, but their binding impact beyond the individual cases is considered weak.

As a consequence of their findings, the authors opt for mandatory adjustment of rates following the adjustable rate index published by Bundesbank. While this rate is an asset rate, i.e., does not directly reflect changes in the refinancing situation of the lender and incorporates therefore industry-wide sluggish adjustment behaviour, its use is advocated because it best reflects the competitive situation. Furthermore it includes a mix of new and old contracts, levelling out the empirically observed spread increase over the loan lifecycle.

b) Models for Regulation and Conclusions

A number of guiding principles can be derived from the reviewed cases. The key point for rate adjustment is that, while indexation is not required in the majority of countries, useful instruments for the government of adjustments are largely missing. What alternative models exist, and what could be an acceptable European solution?

To enforce standardization of ARM rate adjustment through the use of indices is nothing other than an elegant form of dynamic price control. This may be justified if there is a significant imbalance of power between lender and borrower. Such an imbalance may arise because of high information costs for the borrower over alternative loan offers (increasingly irrelevant), or because the borrower's threat to change the lender becomes less credible over time because of high transaction costs, through ageing and other loan seasoning factors.

The imbalance is less likely to appear in the underwriting situation: a general usury clause could be considered, but is in practice only applicable to extremely rare outlier cases (see the examples of Sweden, France). Rather, improved information standards and progress in information technology will reduce the scope for abuse of power here. In general, under national civil laws sanctions will contain the pricing behaviour for the underwriting situation.

For the situation of a current loan, one alternative lever - compared to enforced index use - could be to further act towards reducing the costs of prepayment. In fact, almost all surveyed countries do not allow for prepayment penalties on adjustable rate loans; this has however developed for other reasons, namely protection of the borrower from general interest-rate risk. Depending on the level of transaction costs of prepayment, the level of imbalances of power between both contract parties changes. However, effective control of transaction costs is difficult, and information gaps will continue to exist for some borrowers.

Use of published rate series (see Spain) is a more promising strategy. Large deviations of seasoned contract rates from the median or mean rates observed for new contracts could be sanctioned. The principle is that, if adopting price control, asset-asset comparisons are preferable to asset-liability comparisons, as they allow for more flexibility for the lender. Typically the government would provide the necessary information services (e.g., Central Bank or Central Statistical Office). Surveying asset rates is also an avenue frequently adopted in rental laws, where flexible price control measures based on surveys have become increasingly popular[93]. The principle alternative, cost indices, are however allowed in most countries that have enforced use of indices. Also, typically the lender can choose among offering several alternative indices.

In cases of wholesale refinancing via issuance of capital market instruments, benchmark prices are in any case typically used as the basis for determination of refinancing costs, as our evidence shows. Problems could appear in the case of retail refinancing via deposits; here a lender would prefer cost-of-funds indices to capital market indices. The potential choice between several alternative indices should therefore leave sufficient degrees of freedom for the lender.

The study team believes that a requirement to apply *any* predetermined index for new contract conditions on existing contracts would suffice to both eliminate the loan lifecycle spread problem for the consumer and remain feasible for lenders[94]. The suggested form is to require the lender to use at least an index that he both periodically publishes and disseminates to his customers. The lender should be required to make the history of the index accessible to the consumer before underwriting. Margins for existing borrowers would remain fixed (or predetermined, in case of teaser rates) over the life of the loan (although they may differ from margins offered to new borrowers). In the case of reviewable rate mortgages, this change suggests that lenders will have to set a margin (sequence of margins) for the loan at the onset.

The reason for not enforcing external or official indices is that the key to the empirical problems observed is to ensure the equality of pricing of new and seasoned contracts. In a modern information environment there is no deeper reason to enforce the use of external indices, which would be equivalent to a price control, as the threat to be sanctioned by the loss of new mortgage business would punish the lender in case of strong deviations from industrywide behavior.[95] By allowing lenders to use their own indices, sufficient degrees of freedom would be created to ensure more room for price competition, or the short-term adjustment of conditions to individual cost changes.

93 For instance the German comparative rent system defines feasible zones around the mean rental rates recorded on a domestic rental housing market. The control system is „soft“ in that it allows the mean rent to rise with general market conditions. It penalizes outliers.

94 This appears to be the practice in Portugal. However, the expert survey did not yield sufficient clarity over the exact regulation.

95 The only, unlikely, scenario for abuse is the case of a lender who does not acquire new business.

3. Early Repayment

a) Overview

(1) Introduction

Whether there is universal right of repayment of the outstanding principal before maturity ("prepayment option") plays a central role in determining consumer utility in mortgage lending. The prepayment option gives the borrower the right to either refinance his mortgage - typically at a lower interest rate - with the same or another lender ("refinancing"), or substitute it with his own funds. A central issue is that a typical reinvestment loss for the lender may be so high as to potentially dwarf other cost elements of the mortgage loan, even the credit risk[96]. This reinvestment risk is called "prepayment risk"; like other risk elements it will have to be insured against by an economic agent which will charge a market price. The companion piece to the universal prepayment option is the contractual exclusion of prepayment, where - in principle - the borrower bears the interest rate risk.[97]

Typically, the general good worth protecting by introducing a universal prepayment option, such as established by Article 8 of the Consumer Credit Directive, is identified along three lines of argument:

1. The consumer should be protected against the consequences of a potentially large financial burden, which might fall on him when unforeseen extreme cases materialize ("hardship cases"): for example the death of spouse or divorce, or an enforced house sale (e.g., by change of employment, or unemployment). In the case of financial distress, early repayment might save the borrower from mortgage foreclosure and/or consumer bankruptcy, provided that the financial advantage derived from it is sufficient to render the debt service burden more affordable.

2. The consumer should be guaranteed physical and/or financial mobility, which may quite generally conflict with the execution of long-term financial contracts. In case of a house sale, for instance, early repayment gives the borrower more flexibility to realize the equity in the loan, and at the same time to move to another house.

3. Regardless of his personal situation, the consumer should be given the right to benefit from favourable changes in the interest-rate environment. The argument could be extended to taking advantage of favorable changes in the competitive position of his lender (changes in spreads)[98].

96 The loan losses in single-family residential mortgage finance will be typically in the range of 5-20 bp (0.05%-0.20%) of outstanding loans. As we will see, prepayment risk may cause costs of a multiple of this factor.

97 As the wide market for adjustable rate mortgages shows, where borrower bears interest-rate risk as well, this is not an unusual, or illegitimate, situation.

98 This point is particularly relevant in markets with high price dynamics, as for instance the United Kingdom market in the past years.

> Behind this argument stands the fundamental question, which of the two contract parties is better able to manage interest-rate risks. [99]

One can show that these, both tangible and intangible, benefits for the consumer convert into tangible "insurance" costs, typically incurred by the lender or the capital market investor. The level of insurance costs and benefits distributed will strongly depend on the specific legal and economic solution adopted.

If a universal prepayment option exists, the key economic issue is whether exercise will be combined with contractually agreed penalties (ex-ante, a contingent price), or with a compensation for the reinvestment loss (or gain) the lender incurs (ex-post)[100]. Combining whether the option exists or not with different penalty formulations yields a number of possible models, that any European regulatory initiative needs to address.

(2) Regulations

Table III-4 gives an overview over the findings of the study team on early repayment.

- The large majority of countries surveyed establish a *universal right to prepay mortgage loans* during the time period the interest rate is fixed; i.e., the prepayment option is mandatory for a mortgage contract. These countries include: Italy, France, Portugal, Spain, Denmark, Belgium (regulated loans), Ireland, the Netherlands, and Sweden. [101] Denmark is a special case in that loans can be refinanced by non-callable[102] bonds which may, however, be repurchased by the borrower ("delivery option"). Limitations concerning minimum amounts to be prepaid are common. The form of regulation differs vastly, from written law to codes of conduct.

- A small group *leaves prepayment to contractual freedom*, including the potential exclusion of the option: Germany (only fixed rate mortgages) and Austria. Germany and Austria in turn allow explicitly for exclusion by law, but cap the maximum period of exclusion for 10 years. It should be noticed that German case law entitles the borrower to dissolve from the contract in hardship cases, and - the subject of a recent Federal Court (BGH) decision - also house sales. Article 8 of the consumer credit directive would interfere with contractual freedom, if transposed literally.

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99 It is interesting to note in this context that Belgian lawmakers have only recently made legal, what the mortgage market had anticipated already: the existence of adjustable rate mortgage, and hence of contracts that shift interest rate risk to the borrower.

100 There exists a legal position that would interpret the inscription of prepayment penalties into a mortgage contract as a „lump-sum compensation„. We prefer here the term market price, as there is not necessarily any relation between the level of penalty contractually determined and the loss the lender incurs.

101 Belgium (for regulated loans under Art.26 of the Mortgage Lending Act), Denmark, Finland (Chapter 7 section 12 of the Consumer Credit Act), France (Art.L 312-21), Ireland (section 121 (1)of the Consumer Credit Act), Italy (Art.40 Testo Unico), the Netherlands (Art.8 of the Code of Conduct), Portugal (Art.1147 of the Civil Code and Art.3.2.of Decree-law no 328-B/86), Spain (Ley 2/1994) and Sweden (section 20 of the Consumer Credit Act)

102 Non-callable Danish mortgage bonds bear no option for the issuer (the borrower) to prepay at par (nominal value of the debt), ie. a prepayment option at par. Instead the borrower has the option to repurchase the bond at its market price (delivery option). Non-callable bonds have lost economic importance over time relative to callable bonds, which include a prepayment option at par.

Table III-4 Mortgage Prepayment for Consumer Lending in Europe, an Overview

Country	Prepayment Option on Fixed Rate Contracts	Prepayment Penalties*	Source of Regulation	Treatment of Adjustable -Rate Mortgages
Austria	Contractual exclusion of prepayment possible.	Contractual determination possible.	Written law.	Universal (loans over 10 years: 6 months notice period). Penalty can be agreed on.
Belgium	Universal.	Costless up to 10%/yr. Contractually determined penalty, capped by law max: 3 mths. Interest. No penalty in certain personal hardship cases.	Written law.	Universal. No penalty.
Denmark	Universal.	For non-callable bond refinanced loans: no penalty. For callable bond refinanced loans: implicit yield maintenance penalty (payable to capital market investor). No penalty chargeable by lender: administration fee.	No Written Law.	Universal. No penalty.
Germany	Contractual exclusion of prepayment possible; Universal for some cases (recent case law, see text).	Yield maintenance penalty with net margin compensation.	Written law. Penalty: case law.	Universal. No penalty.
Greece	Universal.	Contractually determined penalty, max 6 mths interest.	No written law. Penalty: Main lenders practice.	Universal.
Finland	Universal.	Yield maintenance penalty (if new rate of same creditor is lower).	Written law.	Universal.
France	Universal. Contract may prohibit early repayment of less than 10% of loan amt.	Contractually determined penalty max 6 mths Interest/3% of prepaid balance. Penalty must be waived in specified hardship cases.	Written law. Penalty: Central negotiations in Conseil Nationale du Credit.	Universal.
Ireland	Universal.	Contractually determined penalties.	Written law.	Universal. No penalty.
Italy	Universal.	Penalty depending on refinancing situation. Maximum must be advertised.	Written law. Penalty disclosure requirement.	Universal. Penalty 1-2%.

Luxemburg	Universal.	Contractually determined penalties.	No written law.	Universal. No penalty.
The Netherlands	Universal.	Costless up to 10%/yr. Yield maintenance penalty (if new rate of same lender is lower). No penalty required if borrower moves, or in hardship cases.	Code of Conduct.	Universal.
Norway	Universal.	Yield maintenance penalty.	No written law.	Universal.
Portugal	Universal.	Contractually determined penalty. Maximum n.a.	Written law.	Universal.

Country	Prepayment Option on Fixed Rate Contracts	Prepayment Penalties*	Source of Regulation	Treatment of Adjustable -Rate Mortgages
Spain	Universal.	Contractually determined penalty max. 2.5% of outstanding loan vol (may be higher, if lender proves damage, effectively yield main-tenance penalty).	Written law.	Universal. Penalty max. 1% of outstanding loan vol.
Sweden	Universal.	Yield maintenance penalty.	Written law.	Unversal. No penalty.
United Kingdom	Universal.	Contractually determined penalty.	No written law. Penalties: contractual freedom.	Universal. Discount claw back allowed.

Source: own survey. Notes: *for a discussions of the different contract types see below.

While prepayable mortgage loans are lawful everywhere, including Germany and Austria where exclusion is the norm, contractual freedom also everywhere allows for restrictions on exercising the right through prepayment penalties. There are two competing concepts: a compensation concept, i.e., a partial or full compensation of the loss of value of the mortgage asset for the lender, and a market price concept, i.e., the interpretation of a penalty as a price that is contractually determined for the contingency of early repayment[103]. The following regulations apply to fixed rate mortgages (national definitions):

- Prepayment penalties are often structured as a compensation for the loss in asset value that the lender incurs through prepayment, plus in some cases foregone profit of the lender (yield maintenance, (net) margin maintenance). The Netherlands (for some cases), Denmark (see below), Sweden, Finland, and Switzerland apply such a method. In Spain, the lender may charge a higher penalty than that indicated by law, in case of a severe asset loss (without considering foregone net margin), implying a similar approach. Interesting to note is that the Swedish legislation has introduced a duty for the lender of minimizing the loss by reinvesting the prepaid sum as favorably as possible.

  The compensation interpretation is, however, not entirely clear in the case of prepayment *gains* for the lender in situations where the interest rate has increased. The Netherlands and Finland, for instance, waive the penalty in this case by law. If prepayment occurs as rates *rise*, a simple penalty waiver is likely to render a profit to the lender, as he may expect a reinvestment *gain*.

- Prepayment penalties are typically contractually determined, i.e., as part of the contractually determined set of cost elements (rates, fees, penalties), to be paid contingent on prepayment, in: Austria, France, Belgium, Ireland, Spain, United Kingdom, and Greece. However, in the following group of countries the payment is capped by law: France, Belgium, Ireland, and the Netherlands (for the case of a voluntary sale of house). In Spain, the capped penalties appear to be binding only in the case of an ARM, not, however, for FRM (see above).

- Denmark is a special case. The delivery of a non-callable mortgage bond by the consumer automatically implies the payment of a yield maintenance prepayment penalty, by paying the bond investor the market price of the loan (which will be higher than the issuance price, if interest rates have fallen). However, the Danish borrower can at the same time get a prepayment *premium*, i.e., if he delivers a bond that trades below par as interest rates have risen. For the main class of bonds, callable mortgage bonds, the bond can be repaid at par through the call feature. The borrower incurs some administration costs.

The size and calculation methods for penalties differ strongly so that even mortgage loans endowed with a universal prepayment option may become non-prepayable in an economic sense.

All surveyed countries, including those that do not practice a universal prepayment option, limit the form and the size of the prepayment penalty, either in written or case law, with the important exception of the United Kingdom[104]. Germany and Austria confine the maximum exclusion period. Western and Southern European countries cap the maximum penalty. Sweden, Finland, and the Netherlands determine a calculation method on the maximum compensation for losses the lender incurs, with maximum terms. The economic result is, that the maximum interest-rate risk exposure of the borrower in fixed rate contracts is limited almost everywhere, although at widely differing levels. This approach of law makers stands in striking contrast to the absence of regulations concerning interest-rate exposure in ARM contracts[105].

In a small number of countries additional rules specify prepayment penalty legislation even further, to include the treatment of personal hardship cases, and also a simple house sale as a result of a change in the working place. From such case differentiations grey areas may arise that follow the different potential motivations for a prepayment. Examples for case differentiations are:

- Belgium bans penalties after repayment following a life insurance payment (death).
- The Netherlands formulate a mandatory waiver in case of death and in case of house sale under execution, if the consumer is not to be “blamed“ on the default (e.g., unemployment).
- In France, the Conseil Nationale du Credit has a working group that shall determine the contingencies under which the legally stated penalty shall be waived. Hitherto, no consensus between consumer and lender groups has been reached.

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103 The legal and economic differences of both concepts are important: a market price would find its limit in general regulations on good manners, a compensation would be more sharply confined to the damage the lender incurs.

104 In Ireland, in addition to restrictions imposed by the Consumer Credit Act, the transposition of the Directive on Unfair Terms104 plays an important role in protecting the mortgage borrowers. The Director of Consumer Affairs has power to adjudicate on unfair terms in mortgage contracts, especially to review the penalties imposed for early repayment.

105 The classical exception used to be Belgium, where ARMs under 3 years were banned until recently.

The study team observed furthermore that penalties will be frequently waived, or converted as a low mark-up over the subsequent loan in cases of internal refinancings (i.e., takeup of new loan with the same lender, or simple rate adjustment).

It is interesting to note that the majority of countries explicitly or implicitly bans or caps penalties on adjustable rate mortgages, allowing the borrower to protect himself from rate increases by terminating the loan with low transaction costs. Among these are Ireland (ban), Spain (cap of 1%), interestingly enough also Germany (ban)[106], but not in general the United Kingdom where ARMs have the highest empirical significance. Only the possibility to demand („claw back“) prepayment penalties has made the discount war there possible. There is, however, discussion on the accuracy of penalties locking in the consumer for longer than the rate discount period.

(3) Value of the Prepayment Option

What is the price that the consumer has to pay for a early repayment? For theoretical and empirical modelling practice, the prepayment option is addressed as a complex, long-running American interest rate call option, whose value and dynamics are furthermore determined by the behavior of consumers and a specific transaction costs environment. This call option is extremely complex to analyze, and even more so to model with empirical data. As with any interest rate call option, its value

- increases with the length of the remaining debt term over which the option remains current, i.e., the option may be assumed to cost more in Denmark, with typically 20-30 year fixed rate mortgages, than in Germany with a median interest-rate binding period of 5-7 years.
- increases with the volatility of the price of the underlying; concentrating on the financial motives the price of the underlying would be the current interest rate for a loan contract over the remaining maturity. Here, with the EMU convergence, national differences become increasingly irrelevant.
- depending on the option formula employed, decreases with the slope of the yield curve, or any other trend variable that represents market interest rate expectations.
- decreases with increasing specific transaction costs, such as new mortgage origination fees, stamp duties, or prepayment penalties.
- increases with increased borrower awareness and capacity to react to interest rate signals. This is a general trend that is triggered by improved information and borrower education.
- is only loosely related to so-called non-financial prepayments (e.g., personal hardship cases or house sales), as long as these are independently distributed from current market interest rates.

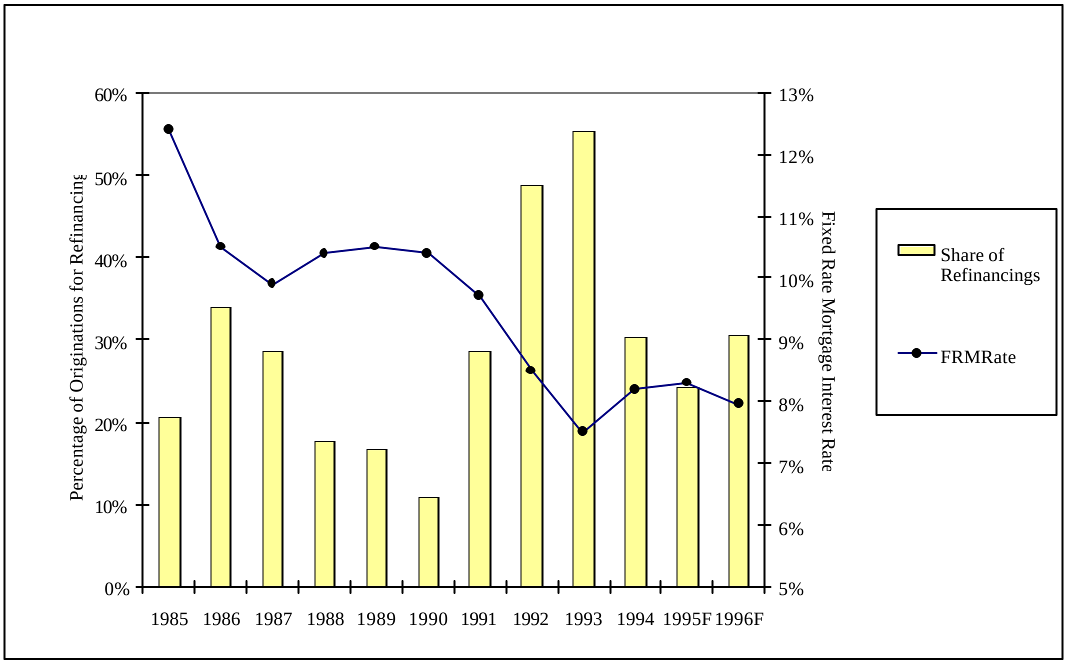
106 The German case stems from the fact that consumers can always prepay adjustable-rate mortgages with 3 months notice (universal prepayment). It is common legal opinion that no penalties shall be charged, if the law states a universal right to prepay.

We concentrate the discussion on the direct empirical evidence of the pricing of the prepayment option on the capital market, by considering the spreads and other available data on the main debt instruments: prepayable ("callable") mortgage-backed bonds (e.g., MBS, most Danish mortgage bonds) and non-prepayable ("non-callable") mortgage-backed bonds (e.g., German Pfandbrief, Danish non-callable bonds). The reason behind this approach is that a spread decomposition delivers an approximation of the prepayment option value that represents the average view of the market, i.e., pools all types of prepayment risk models. The empirical information presented is taken from Dübel and Lea (1996). They studied the country cases of Denmark, Germany, France, the United Kingdom, and the US. While an international comparison suffers from the lack of truly comparable data, this selection already constitutes a wide range of different legal and economic models that helps to understand all existing European legal solutions.

(a) United States

Figure III-2 reports the proportion of mortgage originations for the purpose of refinancing. The data show both a strong cyclicity in response to the main refinancing incentive, the current mortgage rate, and an increasing trend. Both the trend and the amplitude of the prepayment waves reflect the decrease in transaction costs and the increase in borrower awareness, reactiveness, and information.

Figure III-2 United States: Refinancing as a Share of New Mortgage Originations and FRM Interest Rate



Source: HUD, MBA.

On average over the time period of 1985 to 1996 (forecast) 29% of new originations were refinancings. A simple linear regression yields an annual increase of that rate over the past 11 years of 1.2% that is largely attributed to the drop in transaction costs of refinance.

The standard lending instrument in the US is a 30 year fixed rate mortgage. However, since prepayment is typically costless, the average duration of a fixed rate mortgage with a normal[107] prepayment behaviour is only approximately 7 years as borrowers generally prepay at some point in time. The 10 year government bond yield provides the closest duration instrument and is the standard benchmark for comparison with the 30 year fixed rate mortgage.

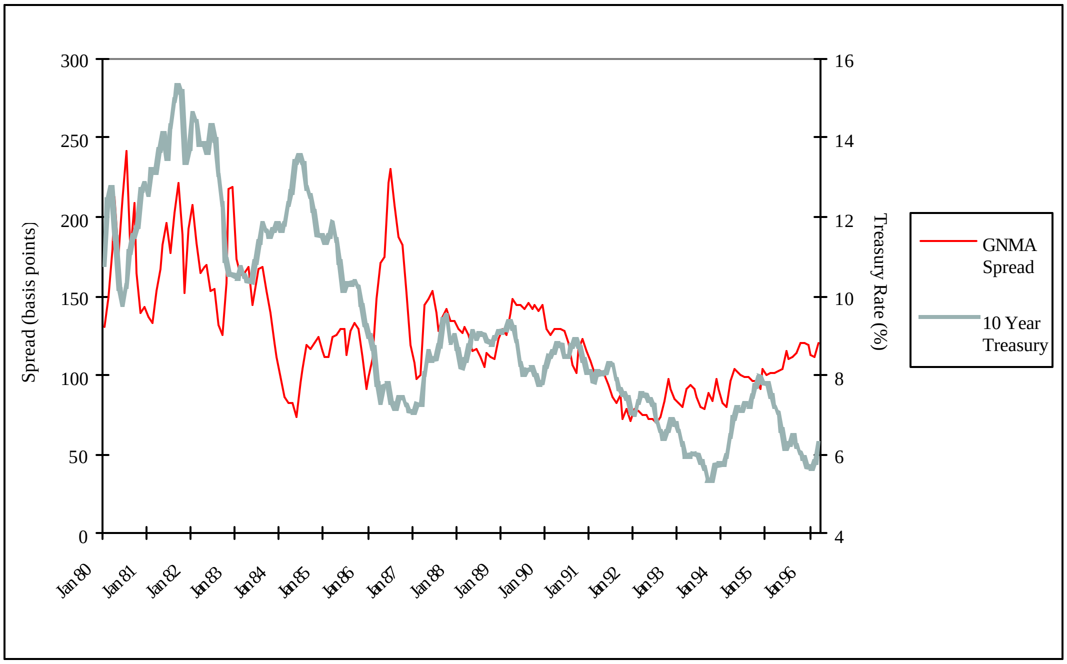
Many of the factors that complicate spread analysis elsewhere are obviated by the existence of the mortgage-backed securities market in the U.S. The GNMA-guaranteed[108] MBS is guaranteed by the government, is highly liquid and yields are quoted net of origination and servicing costs. There is a slight tax difference between GNMA and Treasury securities as some states tax interest on GNMA MBS and by law none can tax Treasury bond interest. The magnitude depends on the state tax bracket of the marginal investor but is probably close to zero (the marginal investor may be an institution such as a pension fund or insurance company which is not subject to state income tax). Thus, if the mortgage yield

107 Following a commonly used prepayment standard (100% PSA).

108 GNMA/Ginnie Mae: Government National Mortgage Association, a public agency that issues mortgage -backed securities.

is stated on a bond equivalent basis (i.e., as if cash flows were received semi-annually as opposed to monthly) *then the resultant spread is mostly due to prepayment risk, and hence a reasonable approximation of the value of the option.*[109]

Figure III-3 United States: GNMA-Treasury Spread and 10 Year Treasury Rate



Source: Oppenheimer.

Figure III-3 shows the GNMA current coupon to 10 year Treasury yield spread.[110] As mortgage rates fell below 10 percent in 1986, prepayments accelerated and the yield spread widened sharply to more than 200 basis points. The sharp increase reflected the new awareness of investors about prepayment risk of the securities. The spread fluctuated between 100 and 150 basis points between 1987 and 1990. In the wake of unprecedented liquidation of mortgage assets by thrift institutions for balance sheet purposes in 1989, the current coupon GNMA yield spread widened to 150 basis points again. However, as the market gradually digested the liquidated securities, the yield spread tightened to a low of approximately 70 basis points in 1992, averaging 93 basis points between the beginning of 1991 and the end of 1995.[111]

109 The formula for conversion is BEY= ((1+MEY/1200)^6-1)*200 where MEY is the mortgage equivalent yield and BEY is the bond equivalent yield. Liquidity differences will vary by security.

110 Current coupon refers to a newly issued security priced at par. If a pass-through is priced at par, the prepayment speed assumption does not affect the yield calculation as cash flows are assumed to be reinvested at the coupon rate.

111 The implementation of risk-based capital standards at the end of 1989 also fueled demand for mortgage-backed securities. These standards apply lower risk weights to GNMA securities (0%), and Fannie Mae/Freddie Mac securities (1.6%) than mortgage whole loans (4%). Some analyses have suggested that the savings in capital costs for a constrained institution more than pays the agency guarantee fee (average of 25 basis points.).

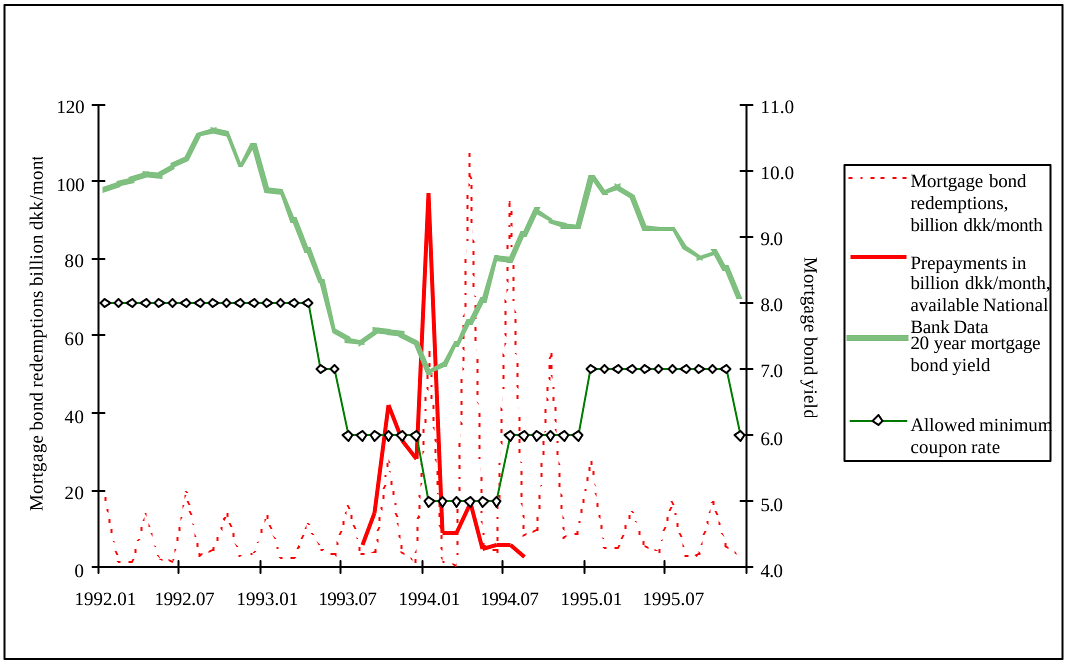
Diamond/Lea (1992) provide both a quantitative and a qualitative comparison of the spreads for the subject countries. Using data from Salomon Brothers, they estimated the value of the prepayment option during the 1988 to 1991 time period at 73 basis points.

(b) Denmark

Mortgage prepayment in Denmark was rare before 1986 primarily due to tax policy reasons that induced households to take up deep discount loans[112]. The incidence of prepayment became significant thereafter, as can be easily seen in Figure III-4. In 1992 and 1993, mortgage bonds with coupon rates down to a minimum of 8%, trading heavily below par, were tax exempt from capital gains, leading to low prepayment rates. However, as interest rates declined in 1993 by almost 4 percentage points, even the prepayment options embedded in the deep discount loans came into the money (i.e., had a positive current value creating an incentive to refinance). In May 1993, government reduced the minimum coupon rate from eight to seven percent, only two months later to six percent, and, by January 1994 to 5%. Another factor that influenced prepayments was the increased attention that the mortgage banks and the media paid to the issue. A massive prepayment wave was triggered by each event that accumulated to 300 billion dkk, equivalent to 30% of GDP, in the matter of a year.

112 Danish discount loans are issued below par and repaid at par, implying a lower coupon interest rate and hence lower prepayment risk. The corresponding capital gain in the bond used to be tax-free.

Figure III-4 Denmark: Total Mortgage Bond Redemptions, Recorded Prepayments and 10 Year Mortgage Bond Yield



Source: Danmarks National Bank, authors' calculations.

As in the US, it is difficult to isolate prepayments for "financial" reasons from those for "non-financial" reasons. The dashed line in Figure III-4 shows total redemptions, which include also ordinary redemptions. Also, mortgage bond redemptions not only reflect behaviors of residential but also of commercial mortgage borrowers, which are traditionally assumed to be more interest-rate sensitive. This makes it impossible to present a chart that would correspond to Figure III-2.

In Denmark, the appropriate instrument to derive market values of the prepayment option is, as in the US, a callable mortgage bond.[113] Bond yields translate with a fairly constant spread into mortgage rates that the borrower pays. It is only recently that the traditionally low spread of 40 bp has increased somewhat, which was to some extent related to higher transaction costs as a result of prepayments.

113 There are several types: The most common is an annuity bond wherein the payments are constant. Serial bonds which feature constant principal payments but declining periodic total payments have periodically been significant as well. Bonds are issued with an original maturity of 10, 20, 30 or 35 years at a stated coupon rate. A series can remain open for as long as 3 years and all individual bonds in the series have the same final maturity date. Issuers can chose from several coupons (e.g. currently bond issues with coupon rates of 9%, 10%, 11% and 12% are open) but an amendment to the Danish Capital Gains Act in 1986 set a minimum coupon rate for issuance which precludes substantial original issue discounts (currently 9% with market yields currently around 10%).

Mortgage bond issuance in Denmark is tightly regulated. Only authorized mortgage credit institutions can issue mortgage bonds ("Realkreditobligationer"). There are nine authorized issuers with the Big 3 institutions controlled 90% of the market in 1995. The mortgage credit institutions are subject to strict limits over the characteristics of the loans which collateralize their bond issues. However, since 1990, banks and insurance companies have been allowed to conduct mortgage credit activities through subsidiaries.

Any interpretation of Danish figures is to be seen against the particular domestic background: Large domestic pension funds and insurance companies have limited investment opportunities with emphasis on the purchase of domestic bonds (Davis (1995)). They dominate the mortgage bond market, not, however, the government bond market, rendering it weakly integrated into the international capital markets.

A paper published in the August 1993 in Danmarks Nationalbank Monetary Review examined the yield differential between individual 20 year mortgage bonds and the 10 year government bonds for the period between January 1990 and May 1993, *before* the large residential prepayment wave (Graven Larsen (1993)). The study analyzes the most liquid series for a number of coupons. It notes that the spread between the most liquid 20 year mortgage bond and 10 year government bond widened from approximately 40 basis points at the beginning of the period to 140 by May 1993 (the average spread across all bonds during this period was 83 basis points.

Table III-5 Denmark: Estimated Spread Decomposition of 20 Year Mortgage Bond over 10 Year Government Bond by Coupon

		cycle		
		decline	**rise**	**decline**
Yield differential for ...% coupon		7/1/90-7/1/91	8/1/91-19/10/92	20/10/92-17/5/93
12	liquidity premium	0.2	0.5	0.5
	call premium	1.8	2.6	3.4
10	liquidity premium	0.2	0.5	0.5
	call premium	0.5	1	1.6
9	liquidity premium	0.2	0.5	0.5
	call premium	0.3	0.5	1

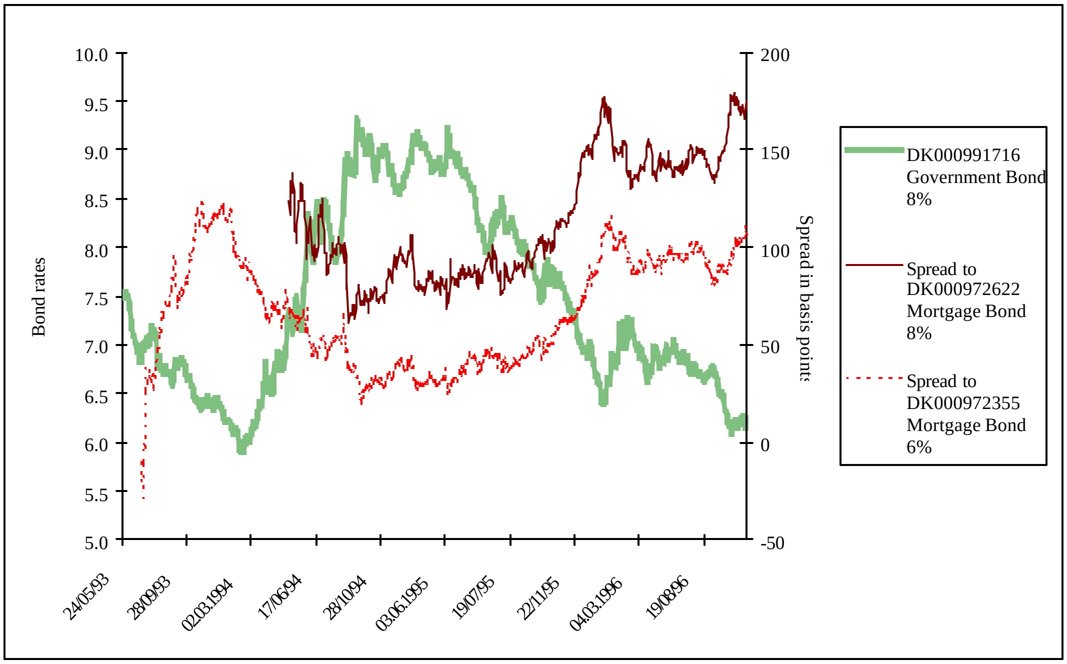
Source: Graven Larsen (1993)

The study concluded that a combination of differences in liquidity, credit risk and investor preferences contributes to a yield differential of approximately 50 basis points. The remaining spread, and the source of the variation, is call (conversion) risk due to prepayment. As shown in Table III-5, the call premium varied by coupon and significantly increased over time. The 12% coupon, which was in the money since 1990, assuming a 100 bp break-even point, reacted strongly to the declining yield curve, by nearly doubling its call premium over the period to 340 bp. The discount bonds reacted with a lag, as expected. The 9% bond, whose prepayment option came only into the money in May 1993, was priced up to 100 bp even before.

Residential prepayments may be assumed to have played a much lower role in bond pricing before 1993 than afterwards. The average spread of the 6%/8%/10% bonds to the 8% government bond reported are reported below. Following Graven Larsen (1993) 50-60 bp should be subtracted for non-prepayment risk cost components:

- for the period until the interest rate trough in January 1994: 87 bp.
- from the trough in January 1994 to the peak in October 1994: 61 bp.
- from the peak in October 1994 until September 1995, when interest rates dropped below 7.5%: 36 bp/85 bp/184bp.
- from September 1995 to November 1996: 87 bp/142 bp/278 bp.

Figure III-5 Denmark: Spreads of a 6% and 8% 20 Year Mortgage Bond relative to 8% Government Bond, 1993-1996



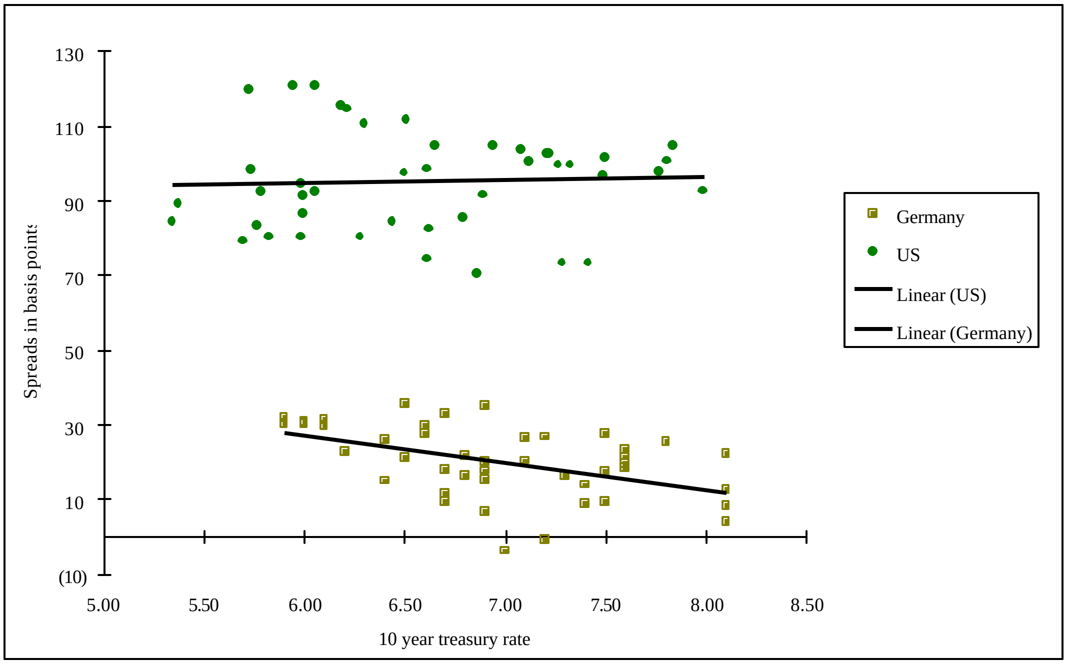
Source: The Aarhus School of Business.

Figure III-5 shows spreads in more detail. The 6% bond bears practically no prepayment risk when interest rates exceed 8%. However, even the discount bond is already interest sensitive during 1995, when the yield curve remained basically unchanged.

(c) Germany

A substantial portion of German fixed rate mortgage debt is refinanced by bonds without the feature of partial or full repayments during their lifetime. These non-callable mortgage bonds are issued by private and public mortgage banks ("Pfandbrief" and "Öffentlicher Pfandbrief"); mortgages are also refinanced by ordinary bank bonds (e.g., by Landesbanken, who refinance the savings banks, and private commercial banks), which are also non-callable. The predominant way of mortgage finance is hitherto exclusion of prepayment. Figure III-6 plots - purely as an illustration - the spreads of callable US GNMA-MBS and the non-callable Pfandbrief over equivalent-duration government bonds. The difference in interest-rate responsiveness reflects the changing value of the prepayment option, as both securities have virtually no credit risk (in the case of US due to a government guarantee) and are highly liquid.

Figure III-6 GNMA and Pfandbrief Spreads and Benchmark Government Bond Yields, April 1992 - December 1995



Source: DGZ, Oppenheimer, authors' calculations.

This mortgage bond premium directly translates into fairly low German mortgage rates, as other cost elements have remained fairly constant over time. The German mortgage borrower receives a discount for waiving the prepayment right in accepting the contract (proportional to the price of the prepayment option); he receives the "insurance premium" for insuring the lender, or equivalently the capital market investor against prepayment risk.

Are there prepayable mortgage loans in Germany? In order to arrive at an overview over the treatment of prepayment in practice and at some quantitative data, a survey among German banks was undertaken in 1996 by the authors, which attracted 47 responses from lenders from all banking groups. Table III-6 reports the reported motivations for consumer applications for revocation contracts ("Aufhebungsvertrag") that lift the interest fixing agreement, as estimated by lenders. Not all of the 21 useful responses had sufficient information in order to differentiate all points - often the figure of "other sales/sales" includes other motives, such as divorce and death of spouse. Note also, that the survey summarizes motives for both partial and full prepayment.

Table III-6 Germany: Borrower Motivations for Applications to Revocation Contracts

Interest rate decline/internal refinancing	11.70
Refinancing other institution	9.30
Bauspar	11.53
Life insurance	5.94
Divorce	*1.82*
Death of spouse	*0.31*
Inheritance	*0.61*
Other sales/sales	54.78
Other reasons	4.10

Source: Zentraler Kreditausschuß Survey, author's calculations.

Given the fact that borrowers are in general, although not always, informed and aware of the exclu sion of prepayments, the pure financial motive has a low weight in application motives: combining interest rate decline and refinancing to other institutions yields a 22% share of the total. This contrasts to data from the other countries, where competitio n and financial effects are main factors in prepayments. The low figure reflects that internal refinancing in Germany has mainly two motives:

- prevention of a default. With the exclusion of prepayment, default becomes an issue despite the fact that banks rather tightly control underwriting loan-to-values and debt-service-ratios; this may be particularly true if house price growth is sluggish, as in the 1980s.
- the extension of the often short fixed rate maturities, with the effect that the borrower can be kept with the bank for an extended period. Indeed, as an additional incentive in approx. 30% of cases banks charge at least part of the prepayment penalty as a mark-up over the new loan.

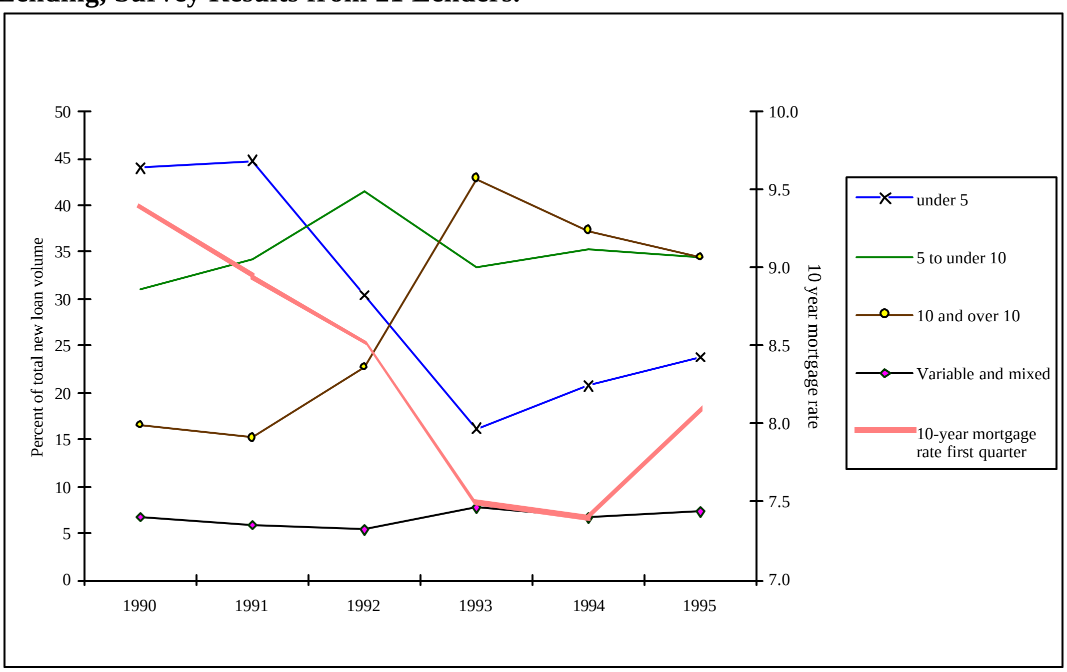
Apart from these motives, banks will typically decline financially motivated prepayments, with the rigor of refusal declining with size of the lender and the degree of maturity mismatch. Against that background the 9.5% share of refinancing to other institutions brought forward as motivations comes as a surprise, as the lender in theory turns down applications with such a motive.

In Germany, contingencies such as sales and allottment of Bauspar loans and life insurance dominate the prepayment motives. These would constitute the "non-financial" motives of prepayment. In general those banks that are part of a private concern or public bank structure will accept prepayments from Bauspar loans and life insurance payments coming from affiliated institutes, and regulate this contingency in the contract. Outside an integrated bank group structure, however, such prepayment motive is generally declined, for instance by small private banks.

Figure III-7 Germany: Share of Revocation Contract Volume in Total Residential Mortgage Lending, Whole Survey Sample

Source: Zentraler Kreditausschuß Survey, author's calculations.

Figure III-8 Germany: Cycle of Interest-rate Binding Periods in Residential Mortgage* Lending, Survey Results from 21 Lenders.



Source: Zentraler Kreditausschuß Survey. *Note: data may include non-consumer residential mortgage lending (e.g., rental housing projects or projects developments as German lenders do not differentiate by investor type)

Despite the necessity of concluding a revocation contract there are significant prepayments in Germany. The acceptance ratio of applications was recorded to be above 50% for the sample, irrespective of the phase in the rate cycle. Figure III-7 shows that the volume of revocation contracts as a share of total residential mortgage lending, an indicator that could be calculated only for a subsample of 13 banks that combine a residential lending volume of DM 23 billion - mainly mortgage banks (8). Prepayments play a significant role if compared to the lending volume. Also, according to the questionnaire, at least one of these banks offers full prepayment as a contract option (portfolio share 2.2%)[114].

Even though 10 year mortgages are available in Germany at the interest rate peak at only a low premium over government bonds, most borrowers are obviously aware of the characteristics of exclusion of prepayment and shift cyclically to short-term fixed rate loans, avoiding therefore negative interest rate risk. Figure III-8 displays that for our sample at the peak of the German reunification interest rate high, only slightly more than 15% of the lending volume was in loans with maturity of 10 years and over; in the 1994 trough this proportion rose to over 40%. Adjustable rate mortgages play no significant role in the sample. The typical borrower's strategy at the interest rate peak would be to start with a short-term fixed rate loan, and refinance later into a 10 year fixed rate loan. This strategy is refined by selecting adjustable rate mortgages with the option to fix the rate for longer for a longer period at some point in time (switching).

(d) Comparison of Country Results

Previous research and this small overview suggest that the prepayment option comes with a market price: for the US this can be approximated to between 70 and 100 basis points, or 0.7 - 1.0% points, for current coupon issuances. In Denmark, one arrives at a substantially lower price for mixed mortgage bonds, e.g., 30 to 45 bp for 7 to 8% percent coupons, but there is a high likelihood of a general underpricing of Danish bonds and hence the option, due to the portfolio regulations of domestic institutions[115]. Higher conditional prepayment rate realisations for individual issuances have lead in the past to much higher call premia in Denmark, too.

For France, the option value for a 9% coupon has been estimated by the Association Francaise de Banques at 38 bp[116], reduced by the value of the prepayment penalty of 19bp. In Britain, prepayments of

114 It should be emphasized that in Germany the exclusion of prepayment in a fixed-rate contract for up to 10 years is a contractual option (ie. it is not imposed by law). Lenders and borrowers have full freedom to conclude contracts including the prepayment option.

115 In the US, internal subsidization of mortgage lending through the Secondary Mortgage Market Institutions leads to a reduced passing on of the premium to borrowers.

116 This is the result of a simulation, not of an empirical observation. Determining the empirical pricing of the option in France is only possible in an approximative manner. The only available direct debt instrument, French MBS issues, have features that disallow the approach taken in Denmark, Germany and the US.

both fixed rate and variable rate mortgages with discounts have been counteracted by a strong increase in prepayment penalties charged, reacting to substantial prepayments: between August 1994 and February 1996 alone the median prepayment penalty in fixed rate mortgage offers rose from 3 to 6 months. German borrowers, who at present typically use non-prepayable contracts, save the option price and pay lower mortgage interest rates, against a reduction of degrees of freedom.

Assuming that a future European monetary policy would result in an interest rate cycle similar to Germany for the time period of 1980-1995 and taking into account lower non-financial prepayment factors such as mobility and housing turnover in Europe, a prepayment option without prepayment penalty would be expected to cost in the range of 40-70 basis points, or 0.4% - 0.7% points, depending on the significantly differing interest-rate binding periods.

b) Models for Regulation and Conclusions

From the empirical overview in Table III-4, four main contract, or product, types can be identified that exist today in Europe. They are typically related to special refinancing techniques:

- Type 1: Contract with universal prepayment option and compensation payment (i.e., yield maintenance prepayment penalty, with or without net margin compensation). This implies the calculation of a compensation for the lender.
- Type 2: Contract with universal prepayment option and contractually determined prepayment penalty. The penalty de-facto functions as an agreed (market) price for exercise of the option.
- Type 3: Contract with universal prepayment option, but without explicit prepayment penalty and instead an interest rate premium (or in rare cases up-front fees) compensating the lender for the costs of the option.
- Type 4: Contractual exclusion of the prepayment option for a specified period of time.

If there were only one legally admitted contract type in the economy, only contract types 1 and 2 would allow for borrower self-selection; in the other two cases, borrowers would be obliged to take or leave the option altogether. A complete range of the 4 contract types may be easily offered in an economy, given that the legal structures are in place, allowing for borrowers to self-select according to their interest-rate risk preferences. This leads to the requirement to structure each of the four contract types

Note also that the comparatively low option value for France is influenced by the fact that typical interest-rate binding periods are 15 years, ie much lower than in the US and Denmark. This, of course, leaves substantial interest-rate risk to the borrower, as after 15 years typically between half and two thirds of the loan will have to be refinanced at current interest-rate conditions. In comparison to the value of other options and transaction costs, the 40 bp estimated for France are still the by far dominating single cost component.

in a way that sufficiently safeguards the interests of the consumer and strikes a balance between costs and benefits.

(1) Type 1: Contract with Prepayment Option and Compensation Payment (Yield Maintenance Penalty)

These contracts are practiced in Sweden, The Netherlands, Finland, Switzerland, and implicitly in Denmark (non-callable mortgage bonds). In Germany they are discussed. The definition entails that the penalty is calculated at the time prepayment occurs (ex-post), following a model that incorporates the yield difference of the mortgage asset and, as will be discussed below, the margin of the bank. With a yield maintenance prepayment penalty, the price for exercising the prepayment option is a variable, as it exactly matches the pay-off for the borrower that itself is a function of the prevailing interest rate relative to the coupon rate as well as other variables. As a result, there will be no financial advantage of exercising the prepayment option as the option is not in the money. However, borrowers have variable opportunity costs of refinancing, plus there may be additional intangible and tangible utilities of having the option (e.g., for personal hardship cases).

Compensation formulae as they exist empirically (see above) allow for a bit more than a full compensation of the lender, as in the case when the prevailing interest rate lies *above* the contract rate the lender can under the typical legal concept expect a gain from prepayment. While the mathematical structure of the compensation formula is straightforward, there are a number of practical problems in determining the parameters.

Problem 1: Maximum duration over which the penalty may be charged

There are problems with yield maintenance penalties if remaining loan terms are long. The level of penalty to be demanded to offset in a present value consideration the pay-off to the borrower swiftly increases with remaining maturity. A market reaction to a yield maintenance penalty could be hence a shortening of maturities, unless, as in the German case, maximum interest rate binding period and maturity are separated by law. Limiting the maximum interest rate binding period introduces an element that must be determined arbitrarily[117] into an otherwise elegant approach. A 10 year maximum period over which penalties would be charged could be one line of a European compromise.

117 However, German law does not restrict the maximum interest rate binding period to a particular borrower group, i.e., there is no explicit consumer protection motivation.

Problem 2: Appropriate calculation benchmark

The two principal alternatives are a comparison of the coupon rate of the mortgage loan to be refinanced with the prevailing mortgage lending rate (*asset-asset-comparison*) or with the prevailing refinancing rate (e.g., the mortgage bond issuance yield, *asset-liability-comparison*), corrected by some measures of saved operating costs and risks to the lender.

The latter involves a compensation of the net margin of the lender. If the lender is not compensated for the margin loss, he will price the expected loss, given his prepayment model, into the mortgage rate or the up-front fees. This is the case for a Danish non-callable mortgage bond, as the lender is not entitled to charge a net margin compensation. In both Sweden and Germany, lenders object to net margins which have been set at a too low, or even negative, level.

Table III-7 abstracts for simplicity from the administration costs. It also shows another point, namely that lenders and borrowers will have different values associated to the event of prepayment, depending on their respective opportunity costs.

Table III-7 Mechanics of the Yield Maintenance Prepayment Penalty

	Ex.	**Lender's View**		**Borrower's View**	
				new credit	own funds
Old Lending Rate	9%				
Yield maintenance (asset-asset comp.)					
New Lending Rate	7%				
plus net margin compensation* (asset-liab.-comp.)		minimum	maximum	minimum	maximum
New Refinancing Rate	6%	loss	loss*	profit	profit**
After-tax Asset Return for Borrower's Investments	4%				

*gross margin, net of saved operating costs and risk premia

**assumption: no tax deductibility of mortgage rates

Note: figures for illustration only.

The table shows that with a net margin compensation, there might be situations where the borrower makes a loss (internal or external refinancing, for the "new lending rate"), or a profit (refinancing with his own funds, e.g., an inheritance). However, lenders should not charge margin compensation for internal refinancings, leading to a discrimination between internal and external refinancing. The point for consumer protection is to avoid double charging by the same lender, while double charging of the net margin in the case of changing the lender is hardly avoidable, because, if banned, the first lender would simply charge the expected margin loss another way. The British discount war has shown that new lenders will reimburse prepayment penalties in the form of incentives given to the switching borrower, so this might not be a particular problem.

Problem 3: Appropriate Discount Factor

Similar difficulties arise with the selection of the appropriate discount factor for the calculation of the prepayment penalty. It goes beyond the scope of the study to explore all feasible alternatives.

Box 5 Practical Issues With Yield Maintenance Penalties in Sweden

Sweden's Consumer Credit Act specifies a yield-maintenance prepayment penalty model. The penalty may be smaller or equal to the difference between the coupon rate and the prevailing government bond rate over the remaining interest-rate binding period, plus 1%. The Supervision Authority has undertaken recently a short study on whether the 1% rule of thumb is justified to approximate the saved administration costs and risk. They come to the conclusion that it is "broadly in line" with lender cost savings, but the lenders claim that the gross spread has meanwhile dropped below 1%. Consumer groups are favourable to the penalty model, but worry about its complexity. Nevertheless they do not advocate any changes.

Lenders had major difficulties with a prepayment wave in 1993/1994 as the first version of the Act calculated the penalty by taking not the government bond benchmark over the *remaining*, but over the *contractual* interest rate binding period. With a steep yield curve and sharply declining rates, the prepayment option was for some time strongly in the money, causing large prepayments. Today there is still a lack of clarity about which discount factor should be used in the calculation.

According to information provided by lenders, the penalty is today 100% applied to all prepayments - even in internal refinancings. In the latter case the lender will typically increase the loan-to-value ratio by the amount of the penalty, i.e., finance it.

(2) Type 2: Contract with Prepayment Option and Contractually Determined Prepayment Penalty

Here, the penalty is fixed in advance either as a formula as a specific amount; it performs the function of an additional price element in the loan offer. An example is the use of the formula "6 months interest up to 3% of mortgage balance", typical in the United Kingdom, or the Loi Scrivener maximum amounts in France. A constant price in case of exercising the prepayment option leaves the lender with the basic interest rate risk due to the ex-ante high uncertainty about whether the option will be exercised (see the experiences of French lenders reported in Box 7).

Box 6 Practical Issues with Prepayment Penalties in the United Kingdom

A survey of contractual prepayment penalties in the United Kingdom that was undertaken by the authors yielded considerable diversity. Penalties are formulated as a multiple of months' interest payment, a percentage of the outstanding balance, but also in some cases as a percentage of the initial balance. Average penalties have risen despite of falling fixed rate mortgage interest levels during 1994-1996, suggesting a potential for mispricing by 1996. Lender groups are observing developments at the moment; no recommendations have been included in the Mortgage Code. The Building Societies Ombudsman, a dispute settlement institution, would define ex-ante defined penalties as reasonable and fair, „where they represent a genuine pre-estimate of the potential loss to the lender of the early repayment" (National Consumer Council (1996, p.5)), and unfair otherwise. Taking literally, this approach would require a commonly accepted prepayment model, which does not exist. Due to the recent use of higher penalties, there are so far only few cases of borrower complaints; interview partners expect a higher relevance of the issue.

As the probability of exactly matching the pay-off for the borrower from prepayment with a contractual penalty is low, finding its right level necessarily becomes a trial-and-error process. This might well result in a prohibitive levels of penalties, as one may argue is the case for many loan offers in Britain. Another important point for consumer protection is that a contractually determined market price for prepayment is in principle arbitrary, as the true costs of prepayment are almost never exactly met. It therefore leaves the potential of high gains from exercising the prepayment option on either side, a situation that might also lead to individual bargaining.

(3) Type 3: Contract with Prepayment Option, without Prepayment Penalty

This is the standard contract in the United States. In Europe it only exists in Denmark. Since no penalties or only minor administration costs have to be paid by the borrower, the value of the prepayment option is priced as an interest-rate mark-up. If the contract becomes the universal standard, as for instance in the US, the costs of prepayment are levied unconditionally on all borrowers alike, regardless of their probability to prepay at some point in time, or their interest-rate risk preference.

Mark-up pricing requires sophisticated prepayment models. The most striking economic problem is that mark-up pricing can lead to higher prepayment rates sui generis since the refinancing incentive rises with a higher nominal rate. As a result, the range of interest rate levels over which prepayment may become profitable over the duration of the loan will rise vis-a-vis contracts with penalties. Furthermore the mark-up will be variable for different contract interest rate levels and thus over time.

The partial self-defeating character of mark-up pricing adds to the cyclicity of the interest rate spread that mainly results from the different prepayment potential of the different contract interest rate levels. Potential instability of interest rates and the high price of the option should be a concern for consumer protection, while hardship cases are less problematic (although more defaults are caused due to the higher debt burden generated by the interest-rate markup). We have shown the practical relevance of the problems described above for the model cases of the US and Denmark.

Box 7 Problems of French Lenders with the Cap on Prepayment Penalties

The main mortgage lenders in France are commercial banks (65% market share) which fund themselves primarily through deposits and short-term money market instruments. As of 1992, only approximately 19% of bank liabilities were in the form of bonds (IMF (1993)). The few wholesale lenders (e.g., Compaigne Bancaire, UCB) fund themselves almost entirely through the bond market.

These different funding strategies have generated significantly different results for these two classes of lenders. French retail lenders, unlike their British and German counterparts, appear to rarely use derivatives to match their - substantially longer - fixed rate lending. The maturity mismatch causes significant interest rate risk in a rising interest rate environment. From the model however, it became clear, that in the presence of prepayment a lower portfolio yield is accompanied by reductions in interest expense, reducing the effect of prepayment risk on capital. As a result, a mismatch strategy may be also *caused* by the existence of prepayment risk. However, as cost centre thinking for residential mortgage lending is uncommon with French retail lenders, these considerations are likely to play only a minor role.

French wholesale lenders have been more hard hit by prepayment as they have been funded through issuance of long-term non-callable debt. UCB, a private institution that holds a 30% share among matched-funded lenders, has reduced its fixed rate lending share from over 50% in the early 1990s to approx. 15% today. The shift towards ARM is to some extent a cyclical phenomenon, but largely related to problems in handling the refinancing, arising from prepayment. UCB does not issue mortgage-backed securities to pass the prepayment risk.

The Chairman of Banque de France has recently named the issue of mortgage prepayment, and indirectly Loi Scrivener, as one of the five major problems facing French banks. The background of this statement may be seen in calculations by Mouillart (1995) that estimate the losses sustained by lenders during the 1986-1988 period at FF 33 billion and of the 1994 wave at FF 8 billion. Partly as a consequence, the BdF regulators have ruled in 1996 that all loans with interest rates less than comparable maturity government security yields plus 60 basis points must be reported to the Board of Directors and the Commission Bancaire.

There is a mortgage bond funding mechanism for the banks that could - in principle - transfer the prepayment risk to the capital market. The Caisse de Refinancement de Hypothécaire (CRH) is an institution that issues bonds that are (over) collateralized by mortgage bonds created and held by the issuing bank. The lender creates the bonds (promissory notes) backed by a pool of qualifying mortgages (maturity over 10 years, LTV no greater than 80%) for an amount up to 80 percent of the principal of the mortgages. These notes are sold to the CRH which raises funds through periodic issuance of bullet bonds with an average maturity of about 12 years. However, both credit risk and prepayment risk of the mortgages remain with the lender and thus the mortgages remain on the balance sheet (1992 volume: FF 72 billion).

In the absence of a full prepayment penalty and given the structure of the CRH, the most secure way for the lender to manage prepayment risk in France is MBS issuance. The 1988 securitization law allowed credit institutions to create Fond Commun de Créance (FCC). The first securitization was done by Credit Foncier de France in 1991. There have been 10 real estate related MBS issued through February 1996, with a total issuance amount of FF 14.4 billion. The relative dearth of MBS issuance reflects the fact that French lenders have priced mortgages below market and that they have only a 50% capital risk weight. As a result, the holding of prepayment risk in the lenders' balances and consequently, the high risks for the financial system are likely to persist. The Loi Scrivener allows for a partial prepayment penalty that has in the past cushioned all cited effects; hence the problems described might have been even greater without this feature.

(4) Type 4: Contractual Exclusion of the Prepayment Option

This mortgage contract/product is the standard in Germany and Austria, where in both cases the maximum exclusion period is limited to 10 years, while the mean interest-rate binding and therefore exclusion period chosen by borrowers typically varies between 5 and 7 years. At its face value, the contractual exclusion of prepayment is economically equivalent to an infinite prepayment penalty as due to the exclusion the lender is not obliged to conclude a revocation contract. However, in German economic practice, the right of the borrower to obtain a revocation contract in personal hardship cases is uncontested. Lenders also in the past generally agreed on a revocation contract in personal hardship cases, however typically not in cases of a sale.

The result of recent case law of the Federal Supreme Court, however, may be the priority of the prepayment motives of mobility/sales and hardship cases over contract execution, making prepayment universal for two of the three main motive classes, except purely financial motives. Our empirical evidence shows that 80% of real life application cases would be affected, if this interpretation prevails. However, at least 10% of applications refer to internal refinancings, which will typically be accepted by lenders, against payment of the penalty. Therefore, the only relevant prepayment motive under which no right is given would be external refinancings, i.e., changing the lender or prepaying with own funds (e.g., inheritances). It is debatable whether a feasible policy towards differentiating the 10% of external refinancing cases from other prepayment motivations could be formulated by lenders. In the mid term their key interest will lie in charging a sufficient amount of compensation to cover their losses (see discussion about contract type 1).

Notwithstanding the interpretation of recent case law, the study team wishes to mention economic arguments which provide justification for the exclusion contract, independently of the German situation:

- There is a certain risk that waivers of the prepayment penalty enforced by competition could lead to financial losses and indiscipline. There are conflicting signals on this point: while in Britain lenders have raised penalties over time despite strong competition, anecdotal evidence from France and Germany suggests frequent waivers, at least in internal refinancing. In the absence of a general underpricing, frequent waivers of penalties would bid up the interest rates of yield maintenance penalty contracts vis-a-vis exclusion and create a cost advantage of exclusion contracts.

- More important are the political risks, i.e., that once prepayment is universal, prepayment penalties that actually cover the lenders' losses could be politically capped. If call protection is gradually removed in a political bargaining process, a non-callable bond refinancing system, as represented by the Swedish mortgage bond or the German Pfandbrief, could be jeopardized.

(5) Adjustable rate Mortgage Contracts

The value of a universal prepayment option without penalty charges in adjustable rate mortgage contracts is low, if compared to its value in long-term fixed rate mortgage contracts. However, it is not zero, as the foregone expected net margin on the loan will remain uncharged. Lenders will try to anticipate the loss from adjustable rate mortgage prepayments and issue the loan at a discount or charge as much profit as possible up-front (by overstating up-front costs). In the United Kingdom, where adjustable rate mortgages are dominating the market, prepayment penalties are common for the discount period of ARMs, but they are often extended over that period to "claw back the discount". A problematic issue is therefore to define and treat the discount cases: they are neither true FRMs (discounts may vary yearly), nor ARMs. The issue of allowing prepayment penalties in adjustable rate mortgage contracts is also strongly related to the level of consumer protection vis-a-vis rate adjustment.

(6) Conclusions

European lawmakers might be tempted to choose one contract type, type 3, with universal prepayment and discarding prepayment penalties, as a uniform model for Europe. The Danish mortgage bank system, which is the only European banking industry offering this contract, is typically cited in this context. This is partially incorrect, however, as Denmark also has (at least) a compensation contract, type 1. Selecting *only* contract type 3, or equivalently limiting prepayment penalties to minimal amounts, would have the advantage of avoiding more detailed regulations on prepayment penalties, achieving somewhat lower default rates and a slight decrease in callable loan rates (through low-prepayment risk borrowers getting pooled with high-prepayment risk borrowers). However, it would have, as we have shown, a negative impact on the European mortgage markets and the banking system. Table III-8 summarizes the arguments.

Table III-8 Tangible and Intangible Costs and Benefits from Transposing a Universal Prepayment Option without or only Limited Compensation to the Lender

	Benefits	Costs
tangible	marginal decrease in credit costs for callable loans marginally lower default rates limited cross-border effects	strong increase in credit costs for prev. non-callable loans (30-100bp) pot. breakdown of non-callable fixed-rate debt refinancing
intangible	improved treatment of personal hardship cases	no self-selection of high- and low prepayment risk borrowers incomplete mortgage market

The cost of mortgage credit would rise from between 20-30 bp (France) to 40-70 bp (Germany) while remaining largely the same in Denmark, where the contract is already in place. The borrower would be deprived of the opportunity to save these costs by taking up some or all interest-rate risk over a limited time period. Inefficient pooling of borrowers with different tastes would take place.

In those countries with well-developed wholesale funding systems, a switch from non-callable to callable bond refinancing would be necessary. This would affect countries with medium and long term fixed rate mortgages, particularly Germany where the Pfandbrief would have to become callable. Lenders in countries without well developed wholesale funding mechanisms may emphasize variable rate mortgages or may be forced to go to securitization which is typically more costly and complex than non-callable bond issuance.

The alternative of accepting a compensation, or yield maintenance penalty, contract, with or without net margin compensation (type 1), would have only limited consequences for existing mortgage products. However, the lender must have the assurance that he can recover his costs. Such a solution would guarantee borrower self-selection and lender's interests, thereby enabling the substitution of contract types with contractual penalties (type 2). Depending partly on developments in Germany, where the legal situation remains as yet unclear, a transposition of Article 8 appears to have gained political feasibility.

The study team emphasizes that feasibility of a transposition can only be achieved, if necessary amendments to Article 8 are adopted (see below), and if the key condition - loss recovery - remains unaltered in cross-border lending practice by eventually deviating national legislations (see discussion on conflict of law rules in Chapter IV, and the proposal in Chapter V):

- It must be clarified in the Directive that the lender shall be entitled to a (maximum) compensation payment up to the sum of additional costs he incurs through early repayment. This is a written reinstatement that a compensation requirement, or yield maintenance prepayment penalty, represents the most accurate way of addressing the prepayment risk. The study team notes ongoing discussion on the difficulties of determining the penalty in Sweden, The Netherlands, Finland, and Germany; this would suggest to await subsidiary law-making before envisaging a European regulation. Developing a prepayment penalty standard on the European level appears feasible in principle, after na tional discussion has intensified and provided useful benchmarks.

- The maximum lock-in effect for the consumer, in turn, should be limited. This is already the practice in the surveyed countries except the UK, where it would be irrelevant in practice. The compensation payment shall therefore cover only a (fictive) maximum interest-rate fixing period. The total chargeable penalty should not be capped arbitrarily on the European level, as this could threaten existing refinancing systems in a number of countries[118].

4. Assignment

a) Overview

Assignment has been covered by Art. 9 of the CCD. The intention of Art. 9 was to protect consumers against the practice whereby terms were inserted in agreements to the effect that the consumer would not be entitled to plead the same defences against the assignee as against the original creditor.

All of the Member States have legislation covering this subject. The general rule in the Member States is that an assignment does not require a consent of the mortgagor. In UK most lenders adopted a “Statement of Practise on the Transfer of Mortages“ which requires the lender to obtain the borrower’s consent.

In some national legislation the notification of the assignment must be given to the mortgagor (France, Belgium) or annotated in the registry book of real estate (Italy). The position of the mortgagor will not be weakend by an assignment, meaning that the mortgage lender in Europe is entitled to plead against the third person any defence which was available to him in the case of the original creditor.

b) Models for Regulation and Conclusions

Assignment gives lenders an additional degree of freedom in i) choosing a refinancing instrument for mortgage lending by enabling securitization, and ii) selling an asset for general business policy purposes.

118 Germany, Sweden and the Netherlands use non-callable mortgage bonds for refinancing. Non-callable debt instruments are widespread as instruments for mortgage refinancing. The French case shows that reducing the maximum penalty may lead to a shift away from non-callable bond refinancing of mortgage loans.

This option has therefore strong positive liquidity and cost of funds effects of which the borrower takes advantage in the form of lower interest rates; its economic significance reaches into basic property rights. The Consumer Credit Directive, following national laws, has therefore taken the lenient approach of protecting only the defences that the borrower would have with *any* lender.

Making it mandatory to seek the borrowers’ consent could indeed create economic problems for lenders. In the UK, borrower consent is routinely sought on new mortgages, but a large stock of mortgages were originated before the relevant court ruling and are probably non-securitizable because it is too costly to seek consent ex-post. So far, securitization has been of low significance in the UK, but problems might occur in the future.

Information disclosure requirements about the possibility of a sale of the asset in the credit agreement appear in contrast a feasible way to improve consumer awareness. Mandatory notification of the act of assignment may be considered, but there should be no direct consequences for the validity of the assignment deal itself should formalities not be respected. A Code of Conduct solution appears preferable.With the increased significance of securitization, new ways of approaching the issue might become relevant.

5. Portability

a) Overview

Portability is the borrower´s right to change the underlying collateral while maintaining the contract. Interfering into basic property rights it has not been introduced in written law in the survey countries.

However, the study team found that many lenders in the UK, where household mobility is traditionally highest in Europe, allow routinely a borrower to transfer an existing loan to the new property he is purchasing. In practice the customer continues with the existing rate and does not incur early repayment fees. This result may be due to the fact that adjustable rate mortgages are predominant.

The case of fixed rate finance may be illustrated with the example of the Netherlands, where some of the mortgage lenders offer the possibility to take along the rest of the loan at the same interest rate in order to finance the new house. If the consumer does not make use of the so called “take along“ scheme, he has to repay and may have to pay a compensation. Whether this option is in the money, depends only on the transaction costs. Otherwise, similar to the assumability option, the portability option shows the inverse economic relationship to the interest rate incentive compared to the prepayment option.

It is interesting to note that a mortgage lender who does not offer the possibility of a “take along“ scheme, is not permitted to charge a compensation[119]. Lenders in other countries, by contrast, do not seem to be willing to offer a service of portability.

Consumer groups are often faced with complaints. For instance, a German client wished to move upon retirement from Germany to Spain, selling his German house. The lender refused both prepayment and portability, although he is active in both countries, thereby restricting the borrower’s mobility.

b) Models for Regulation and Conclusions

The study team does not propose a European regulation for portability. Information about portability policy may be part of Codes of Conduct and should be compulsory for the loan agreement (Article 4).

Material regulations could require the lender to give grounds for refusal, and also be part of a Code of Conduct. In any case, a regulatory solution for early repayment appears the more important as the denial of prepayment might jeopardize the acquisition of the new house.

6. Assumability

a) Overview

Assumability of mortgages describes the right of the mortgagor to transfer the mortgage in the case of a sale of the house to the purchaser. An important subcase is the transfer in the case of a forced sale, giving the borrower an additional degree of freedom through free-handed sale. If the mortgage is instead due on sale, the mortgagor is explicitly deprived of this right (e.g., the U.S.).

Assuming a mortgage is profitable as a financial strategy i.e., if the market value of the mortgage debt is below par, due to a low coupon interest rate of the loan. In this case, the equity in the project, and therefore the amount that the seller gets, is higher than if the mortgage loan has to be prepaid. Obviously, assumability has the reverse dynamics vis-a-vis prepayment: if the coupon rate is low relative to the market rate, the borrower has high incentives to assume (prepayment: low), and vice-versa.

119 Explanatory notes to the Code of Conduct pertaining to mortgage credit, Art. 9/10 III, The Netherlands

In the European legislations reviewed, the borrower does not have the opportunity to transfer the loan to the new owner. This results from the principle of freedom of contract which does not allow the imposition of another debtor on the lender. However, there are nuances. There are the following models:

- Assumption of a mortgage is impossible, unless an early repayment has taken place, in: Belgium, Ireland, Italy, Netherlands, The United Kingdom, and Luxemburg.
- In Denmark, a Code of Conduct regulates the procedure of assuming a mortgage, which is agreed upon as the norm. Lenders need to give grounds in writing when refusing a new borrower. Also, a purchaser can assume or prepay the mortgage without consent of the lender.
- In Germany, assumability is permitted under the Civil Code if there is consent on the part of the lender. If the lender does not refuse within 6 months, a transfer of the loan is considered by law to be accepted. A similar rule applies in Sweden and Greece. In practice, however, the lenders are often not willing to accept loan assumption and they explicitly refuse permission.

b) Models for Regulation and Conclusions

The regulations reviewed do not contain convincing models to ensure that assumability becomes a borrower option. The simple fact that characteristics inherent in the mortgage collateral make a transfer impossible in some countries, forbid a European regulation. Again, early repayment is the more powerful regulatory tool as a denial might jeopardize the property transaction.

In cases where assumability is possible, imposing information requirements for the lender about policies regarding assumability appears necessary, given the considerable value of the option for the borrower.

7. Default and Overindebtedness

The study team decided at an early stage not to cover the default situation and overindebtedness (see national reports).

The default situation has not been covered by the Consumer Credit Directive. In the field of mortgage lending creditors generally include a contract term allowing them to apply penalties and interest on arrears in the event of default. Creditors may also, under certain circumstances, terminate the contract. The legal situation in France may be cited as an example where the borrower in default may take advantage of protective measures. The borrower is entitled to apply to the court for grace periods, and the court can reduce the interest rate to zero and can modify contractual obligations.

The default situation is neither specifically related to mortgage lending nor to consumer credit agreements. Being aware of the risk of segmentation of national law rules the study team does not propose to regulate the default situation specifically with regard to mortgage lending.

European legislation has already approximated the regulations of the Member States relating to unfair terms which have not been individually negotiated contrary to the requirements of good faith by introducing the Directive on unfair terms 93/13/EEC of April 5, 1993. In its annex the Directive considers a term as unfair if it has the object or effect of requiring any consumer who fails to fulfill his obligations to pay a disproportionately high sum in compensation. Mortgage lending falls under the scope of the Directive, therefore the consumer is protected from unfair clauses with regard to the default situation by European harmonized law.

It is furthermore important to note that the Member States are currently very concerned with the problem of overindebtedness. Many countries have introduced specific rules in this field. In some Member States court procedures for debt rescheduling of overindebted persons are provided[120]. The French legislature has introduced a 2-step-procedure: a voluntary arrangement in front of a commission and a decision by court[121]. All these rules are general and are to prevent and to regulate the situation of overindebtedness.

120 Finland (see for more details: Koskelo (1995, p.622-632)), Denmark (Danish Act on Bankruptcy), Sweden (see for more details: Bogdan (1995, p.617-621)).

121 The third part of the French Consumer Protection Code (Loi Neiertz), Art.L 331 et seque.

IV. GENERAL CONSIDERATIONS CONCERNING EUROPEAN HARMONIZATION

The invitation to tender refers to *cross-border lending* as one of the implications of the harmonization of rules in the Single Market. The Report on Directive 87/102 takes it for granted that all Community initiatives should cover not only national situations, but also cross-border situations[122]. The European Parlament is of the same opinion and considers cross-border lending of primary importance in the context of the Single Market[123]:"*Under the law as it now stands, the Community approach has to give priority to cross-border transactions (internal market) and consumer protection. With a view to EMU it is difficult to imagine a Union without Community legislation facilitating the European market in mortgage credit.*"

It should also be clear that this reasoning applies to mortgage lending to a much larger extent than to consumer lending. Additional transaction costs are smaller as compared to the total yield of the loan. Even small differences in interest rates can make it worthwhile for the borrower to take advantage of facilities offered abroad. As a matter of fact, differences in the non-inflationary component of interest rates are still rather high in the EU and markets are extremely segmented, showing that the Single Market concept has as yet not succeeded (see Chapter II). It should be clear that enabling cross-border lending is a vital point of consumer interest.

The existing diversity and complexity of mortgage products shown in Chapter III should be kept in mind before simply concluding that mortgage lending should be regulated by a directive because the law of consumer credit has been harmonised. Actually, a Single Market might lead to a commoditization[124] of mortgage lending, but the driving force should be the market, not regulation. Regulation can also not achieve a protection of the borrower against basic economic risks, such as interest-rate risk (see discussion in Chapter III on early repayment), but also property price risk (generally not addressed by consumer protection). Against this background, the study team is developing different legal strategy alternatives for harmonization.

122 Report on the operation of the Direcive 87/102 presented by the Commission, No. 347

123 Report on the Commission Report on the operation of Directive 87/102, A4-0010/97 presented by the European Parliament,

124 The term „commoditization" denotes a market process in which products become more standardized, implying higher turnover and lower margins (e.g., standard fixed-rate mortgage product).

A. Minimum Harmonization vs. Full Harmonization

Article 15 of the CCD stands for the principle of minimum harmonization which is typical for directives covering consumer protection. It is evident that the impact of a mortgage lending directive will to a very large extent depend on whether it will contain a minimum harmonization clause. The study team will not discuss to what extent the Treaty provides for minimum harmonization. This depends on whether a directive is based on Article 100a of the Treaty or on Article 129a. Furthermore, the question arises whether Article 129a III EEC only refers to actions according to § 129a II EEC or whether it is generally applicable. Finally, the subsidiary rule in Article 3b EEC has to be taken into account, definitely speaking in favour of minimum harmonization but leaving room for total harmonization if so required[125]. For the purposes of the study which does not specifically cover these issues the team presumes that all options are available and should be assessed economically.

It should be noted, that the report on the operation of Directive 87/102/EEC shows some scepticism regarding the principle of minimum harmonization (n°11 et seq.), e.g., by pointing out that the directive has become a “kind of floor for consumer protection standards“. The report refers to the requirement of unanimity in order to explain this phenomenon: unanimity could not be obtained without leaving room for stricter regulation in the Member States.[126] This explanation, however, is no longer valid. When the CCD was adopted it was based on Article 100 EEC. With Article 100a and Article 129a EEC there is no longer the need for unanimity (cf. Art. 189b EEC). In this respect the options for European legislation have increased considerably. From the legal point of view and in terms of majority votes the level of protection could be higher eliminating less protective systems. From an economic point of view, however, this needs further consideration.

Economically, segmentation of the markets and lacking international competition within the Single Market are key obstacles to increased welfare for all consumers.[127] It is doubtful whether mere minimum harmonization would effectively change the situation in this respect. Of course it is true that minimum harmonization aims at improving the free circulation of goods and services across boarders. Based on this principle consumers may rely on a common standard and without doubt this makes foreign products more acceptable and attractive from their point of view[128]. This direct impact on consumers may indirectly improve the situation of providers.

125 Cf. in detail Heiss (1996), ZEuP, p.625; Micklitz/Reich (1992), p. 593 ff.; Reich (1994), ZEuP, p.381, 395

126 Otherwise a small minority or even a single member could have blocked the directive

127 see for more details Chapter II of this study.

128 Heiss (1996), ZEuP, p.639

In the particular case of mortgage lending, however, providers seem to meet obstacles which a minimum harmonization would leave untouched. In addition to the general obstacles discussed in Chapter II, to a very large extent lenders seem to be refrained from offering their products abroad by risks arising from consumer protection rules, that are presumably or actually higher than in their home country. As far as occasional transactions are concerned, it is not worthwhile to familiarize with these rules. With respect to broader activities, lenders have encountered the problem that minor mistakes concerning formalities had extremely disproportionate consequences for their cross border business[129]. A typical example standing for others seems to be the case of German providers who are refrained from offering their products in France.[130] These obstaclea would in no way be resolved by a minimum harmonization.

Only total harmonization could be effective in that respect as it would create a level playing field for cross-boarder transactions over contractual conditions. The outcome, however, would depend on the content of the directive and to what extent the existing variety of products would be reduced by its rules. It is evident that a total harmonization implementing rules which are restrictive for providers would eliminate products depending on a large degree of contractual freedom.[131] On the other hand it seems doubtful that total harmonization could imply a level of consumer protection considerably lower than that in some Member States. The study team doubts that the advantages of a legal framework favouring more cross-border activity are evident enough to compensate for partial reductions in consumer protection as soon as the political legislative process becomes involved.

Given the essential role of cross-border activities in bringing about a Single Market for the benefit of borrowers, the present study should not be limited to these rather pessimistic remarks on minimum and total harmonization. The study team would like to point out how particularly cross-border activities could be facilitated while leaving internal national standards untouched as far as possible. This aims at discussing the legal framework of cross-border activities as such, in particular the conflict of law rules.

In the following we therefore turn to the legal framework of cross-border lending in Europe in order to analyse which obstacles exist and where the situation could be improved by a directive on mortage lending.

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129 See Lutz (1997): "Dans les cas de non respect des lois Scrivener, du calcul irrégulier du TEG, de non respect des conditions de forme la Cour de cassation décide régulièrement l'annulation du contrat. *L' ordre public francais de protection de l' emprunteur ou du consommateur est caracterisé par un foisonnement de dispositions formelles à sanctions paroxystiques, qui dissuadent très efficacement les établissements de crédit étrangers de s'aventuer sur le marché francais. La liberté de prestation de services est ainsi de facto entravée, en tout cas assortie de risques, d'incertitudes et de sanctions dissuasives.*"

130 See Lutz (1997): Cass.ière civ.01.12.1993, Bull.civ I, n° 354, p.246; Cass 1ère civ. 16.03.1994, D, 1994, IR p.85; Banque 1994 n°549, p.94 note Guillot; Banque 1995 n° 555, p.91, note Guillot; Cass.1ère civ. 30.03.1994, JCP, éd. G, 1995, II, n°22.405, p.122, note Gramaize; Pizzio, D 1995, som.com., p.314

131 See Chapter IV above for the case of early repayment.

B. The Legal Framework of Cross-Border Lending in Europe

It would be wrong to say that the difficulties of cross-border lending are due to a lack of European regulations in this field. In order to mention the major bodies of law one may refer to:

- The Second Council Directive on the Co-ordination of Laws, Regulations and Administrative Provisions Relating to the Taking-up and Pursuit of the Business of Credit Institutions and Amending Directive 77/780/EEC[132] as amended by Council Directive 92/30/EEC[133]
- The Rome Convention of 19 June 1980 on the law applicable to contractual obligations[134]
- The Brussels Convention of 27 September 1968 on jurisdiction and the enforcement of judgments in civil and commercial matters based on Art. 220 of the Treaty[135]

1. Second Banking Directive

The fundamental aim of the Second Banking Directive is to create a single Union-wide banking market without internal barriers to the movement of banking services and the establishment of branches within the European Union. A"single banking license" and "mutual recognition" are the instruments to attain this banking market. "Credit institutions" authorized in the Home Member State are entitled in each of the other Member States to offer their services freely to individuals and businesses without the need for any further authorization by the Host Member State. This goes beyond "national treatment", which merely entitles a foreign bank to the same treatment as a domestic bank.

In the wake of the Single Market for financial services, large parts of the European banking community have taken for granted that the Directive would remove all legal barriers for cross-border transactions within the EU.[136] They have been disappointed in two respects:

1. Limits to the freedom of services and establishment have continued to play an important role as the Directive requires that a credit institution operating under a single license must comply with host-country rules adopted in the interest of the "general good" (Art. 19 IV and Art. 21 V). This "general good" has been invoked by foreign supervisory authorities to an unexpectedly great extent.
2. Civil law courts deciding on litigation concerning cross-border transactions did not follow the rules and principles of the Second Banking Directive.[137] Contrary to the principle of home country control and mutual recognition they tended to apply the law of the host country in order to protect customers.

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132 89/646/EEC, OJ 1989 L386/1

133 92/30/EEC, OJ 1992 L110/52

134 Convention, OJ No L266, 9.10.1980,p.1

135 Convention, OJ No 189, 28.07.1990, p.2

136 Wolf (1990), WM, p.1941-1952 (1943): „ The principle of mutual recognition in the Second Banking Directive will have the effect of introducing financial products of other Member States without the detour of international private law."(originally in German language); Schäfer (1992), p.81

This development has turned the attention to the following legal aspects:

- To what extent does the Treaty's guarantee of freedom of servic es and establishment rule out the application of host country rules against providers offering services construed according to the legal framework of their home country (Member State)?
- To what extent does the Second Banking Directive and the principle of mutual recognition determine the application of civil law rules, especially concerning consumer protection? [138]
- How does the harmonization of conflict of law rules (Rome Convention) and of procedural law (Brussels Convention) affect the legal situation of cross-border transactions?

These issues have led to a flourishing discussion on general aspects of a European Civil and Commercial law[139].

As far as the effects of the Treaty were concerned, focus was on the decisions of the European Court. The situation became even more complex as the Court was about to introduce new distinctions: rules concerning the distribution were supposed to be under lesser control (only discrimination) than rules concerning the product itself (Keck and Mithouard[140]). It is obvious that this distinction is difficult to make as soon as financial products are concerned insted of corporal goods. A European Court decision which was expected to clarify the problem, however, turned into another direction by limiting the distinction to host country rules rather than home country rules. In a case concerning the offering of financial services by cold calling[141] the stricter rules were applied anyway as host country rules were concerned. On the other hand it was quite clear that not only supervisory rules but also rules of civil law could be considered to be an obstacle to the freedom of services not justified by the "general good".

With respect to the Second Directive, however, focus was on conflicts with the supervisory authorities in the host country. This did not exclude conflicts about civil law rules as the authorities also referred to these when deciding on the legality of activities in the host country[142]. Civil law courts in general did not even take into account the Second Banking Directive as they do not apply supervisory law/public law. This distinction has become crucial and should be borne in mind when efforts are undertaken to

137 Communication of the Commission, p.21: The Communication has taken this into account in the sense of considering it *likely*; cf. in this sense as far as functional rules are concerned Troberg (1989); p.35-72 (65); Sousi-Roubi (1990), Revue de droit bancaire et de la bourse, p.155-158; Schäfer (1992), p.81

138 For a discussion of this aspect cf. Sousi-Roubi (1990), Revue de droit bancaire et de la bourse, p.155-158:"...Cela conduit à poser la question de la loi applicable: est-ce celle du pays d'accueil ou celle du pays d'origine?..."; Troberg (1989); p.35-72 (65); Schäfer (1992), p.81

139 Sousi Roubi (1990), Revue de droit bancaire et de la bourse, p.155 (156); (1993) Dalloz, p.183; Pardon (1988), La loi applicable, Banque et Droit, p.33

140 EuGH, decision of November 24,.1993 -RsC-267/91 and C-268/91, Petschke (1994), EuZW, p.107-111

141 EuGH decision of May 10, 1995 - Rs C-384/93 (Alpine Investments BV v. Minister van Financien), NJW 1995, p.2541-2543; Reich, Anmerkung zum Urteil, EuZW 1995, 407

142 e.g.:Belgium, see for mor details Hoffmann (1994), p.313-323 (321)

determine and limit the effects of the “general good“ in the context of the Second Banking Directive. Time will show whether the Commission Interpretative Communication on freedom to provide services and the interest of the “general good“ in the Second Banking Directive[143] fully meets this requirement.[144]

2. Rome Convention

Very soon it became clear that the conflict of law rules were of the essence. These were about to be harmonized by the entering into force of the Rome Convention. Civil courts in the Member States should and would apply these rules to determine what law governed the contractual relationship. Unfortunately there was and continues to be considerable confusion concerning the effects of the Convention on mortgage lending and the applicability of consumer protection legislation.

In principle, the Convention corresponds to the Single Market concept by granting *party autonomy*, i.e., the parties to the contract can choose the applicable law (Art. 3). This also corresponds to the principle of home country control and mutual recognition: Anyone offering services in other Member States may see his law applied by choosing the applicable law.

(1) Consumer Protection

The free choice of law, however, is limited with respect to consumer protection. As there have been and probably still are basically differing views, the *wording* is of the essence:

Article 5

Certain consumer contracts

1. This Article applies to a contract the object of which is the supply of goods or services to a person (“the consumer“) for a purpose which can be regarded as being outside his trade or profession, or a contract for the provision of credit for that object.

143 Commision Interpretative Communication on freedom to provide services and the interest of the general good in the Second Banking Directive, Bruxelles, 20.06.1997, SEK (97)1193 final.

144 As the last footnote shows this does not mean that the study team considers the communication to be a a future text. Based on practical experience one may doubt whether credit institutions will risk conflicts with national courts when exercising cross border transactions. It may be surprising that credit institution have not acted as the communication now recommends: p. 21 bring forward the arguments.This is not due to a lack of information but to the fact that responsible bankers shy away from building up large volume of credit which might turn out to be an source of enormous loss. One must also take into account that contraventions may be criminal offences that may have severe personal consequences. Empricically, bankers have turned out to be very risk adverse in that respect by preferring to retreat from markets where such conflicts appear.

2. Notwithstanding the provisions of Article 3, a choice of law made by the parties shall not have the result of depriving the consumer of the Protection afforded to him by the mandatory rules of the law of the country in which he has his habitual residence: if in that country the conclusion of the contract was preceded by a specific invitation addressed to him or by advertising, and he had taken in that country all the steps necessary on his part for the conclusion of the contract, or if the other party or his agent received the consumer's order in that country, or if the contract is for the sale of goods and the consumer traveled from that country to another country and there gave his order, provided that the consumer's journey was arranged by the seller for the purpose of inducing the consumer to buy.

It should be noted that "provision of credit" is mentioned in the context of credit for the supply of goods or services ("for that object"). It is evident that mortgage credit and also consumer credit without a specified purpose do not fall under this provision. The question may remain whether lending can be considered to be the "supply of services". There are good reasons to deny this[145], in particular with respect to the statements documenting the consideration of the contracting parties[146], having considerable weight. But it does not seem to be the common opinion in Europe. In some statements, Art. 5 is generally considered to be the conflict of law rule for consumer protection without paying special attention to the *specific wording* of this provision referring explicitly to *certain types of credit*[147] and ignoring the position of the contracting parties. Recently, however, this position has gained considerable weight by the Commission interpretative Communication. [148]

This regrettable controversy has caused considerable confusion among lenders.

(2) Mandatory Rules

If Art. 5 is not applicable, the free choice of the applicable law can be restricted by Art. 7:

Mandatory rules

1. When applying under this Convention the law of a country, effect may be given to the mandatory rules of the law of another country with which the situation has a close connection, if and in so far as, under the law of the latter country, those rules must be applied whatever the law applicable to the contract. In considering whether to give effect to these mandatory rules, regard shall be had to their nature and purpose and to the consequences of their application or nonapplication.

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145 Audit (1992), Droit International Privé, p. 643: „*Le contrat doit avoir pour objet la fourniture d'objets mobiliers corporels ou de services, ou le financement d'une telle fourniture; sont ainsi notamment exclus les contrats ayant pour objet l'achat d'immeubles*."; Witz (1995), p.273-311 (283); Burnside, (1993), Revue Banque et Droit, p.19; Mayer (1993), Revue Banque et Droit, p.44; Synvet (1993), Revue Banque et Droit, p. 15; Klotz (1997), RIW, p.198; Mattout (1997), p.15; Hoffmann, (1989), IPRax, p.261-271 (267); BGHZ (1994), NJW p.262; Jayme/Kohler (1993), IPRax, p.357-371 (358); von Bar (1991), p.333; Martiny (1996), p.616

146 see for more details: Report on the Rome Convention by Giuliano/Lagarde (1980), Art.5, Abl.1980 Nr..282, 23

147 Articele 5: „This article applies to a contract the object of which is the *supply of goods or services* to a person for a purpose which can be regarded as being outside his trade or profession, or a contract for the provision of credit for that object."

148 Cf. the Commission interpretative Communication, p. 26 globally referring to contracts concluded with a consumer

2. Nothing in this Convention shall restrict the application of the rules of the law of the forum in a situation where they are mandatory irrespective of the law otherwise applicable to the contract.

Without going into details it may be stated that this has turned out to be one of the most difficult provisions of the convention. The following issues have arisen:

When is a rule mandatory in the sense of Art. 7 II (mandatory irrespective of the law otherwise applicable to the contract)?

- How can these rules be distinguished from mandatory rules in the sense of national legislation?
- Is it justified to follow the wording and simply apply the law of the forum or is an additional connection to the forum state required? If yes, which?
- Can rules regarding consumer protection be mandatory in the sense of Art. 7 II or is Art. 5 exclusive in that respect?

To the detriment of legal certainty for cross border transactions case law is developing very erratically and within national segments. As it is lacking competence to guarantee a uniform interpretation[149], the European Court has turned out to be a major roadblock. For practical purposes involving high economic risk the flourishing scientific discussion[150] may not offer sufficiently reliable guidelines.

One should see that Art. 7 gives enormous effect to the rules of international procedural law: Art. 7 II refers to the law of the *forum state*, i.e., it may be crucial which court can and will be addressed in case of litigation. Art. 7 I refers to the law of non-forum states but still the place of litigation is important as courts may strongly differ in applying this rule. Furthermore, on account of a reservation (Art. 22 I a) Art. 7 I is not applied in Ireland, Germany, Luxembourg, and the United Kingdom, therefore, there may be enormous differences litigating in or outside these countries.

3. Brussels Convention

It should now be evident that procedural rules have gained considerable importance in cross-border transactions in spite of the harmonization of international private law. In this respect the (very early) European harmonization by the Brussels Convention of 1968 comes into play. Again the question arises whether the consumer protection of this convention applies to loans and in particular mortgage credit. The Brussels Convention primarily focuses on insurance contracts (Art. 7 et seq.). Beyond that it

149 The second Brussels Protocol (O.J. 1989, No.L48/1) confers the institutional power upon the European Court to interpret the Convention, and this requires the unanimous ratification of EC Member States, which is still outstanding.

150 Cf. Kaye (1993), The new private international law of contract of the European Community, p.239-268; Kropholler (1996), Internationales Privatrecht, § 52 IX; Loussouarn/Bourel (1996), Droit International Privé, p.426

contains special rules applying to consumer contracts. As the wording of Art.13 corresponds to that of the Rome Convention the same issues appear as regard Art. 4 of the Rome Convention.

Based on the report by Schlosser on the Brussels Convention in which he clarifies that credit contracts do not fall within the category of the „supply of services“[151], there is good reason to say that the provision does not apply to mortgage loans (as in the case of the Rome Convention).[152]

The crucial difference, however, can be seen in the fact that the Brussels Convention does not contain any further rules regarding international jurisdiction and consumer protection (as opposed to Art. 7 and Art.15 II of the Rome Convention). This means that Art. 17 can be applied, i.e., there is room for jurisdiction clauses linked with the product offered in a cross-border transaction.[153] Providers therefore have good reasons to use jurisdiction clauses referring to their home countries and this has become widespread practice. Especially if Art. 7 I of the Rome Convention does not apply (Germany, England), the mandatory rules of the host country cannot come into play in the forum state. The home country courts will most likely respect the choice of their law and decide accordingly.

In the case of mortgage credit, however, one must bear in mind that the collateral is situated abroad. To initiate foreclosure proceedings the home country judgment will have to be recognized. At this point the public policy clause (Art. 31) of the Brussels Convention may apply, rendering the foreign judgment useless as far as the collateral is concerned. The creditor, however, may still take recourse to any assets situated in the home country or anywhere else outside the host state. The outcome thus depends on the individual case. This situation is not satisfactory as regards both sides of the market. From the point of view of the consumer the tendency to use jurisdiction clauses increases the risk to be involved in litigation abroad.

4. Conclusion Regarding Legal Obstacles

It is evident and it is the view of practically all experts in this field[154] that the rules governing cross-border transactions are far from creating a reliable and balanced legal framework supporting the freedom of services in the Single Market on one hand and guaranteeing an appropriate level of

151 Schlosser (1978), Report on the Brussels Convention, Nr.157, Abl.5.3.1979 Nr.C59, 71-151

152 see for more details: Kropholler (1996), Europäisches Zivilprozeßrecht, p.181; O'Malley/Layton(1989), European Civil Practice, p.501

153 A jurisdiction clause according to Art. 17 is not excluded by the fact that Art. 6 § 4 in connection with Art. 16 § 1 litt. a may grant jurisdiction where the mortgaged land is situated. As far as the contractual litigation is concerned this jurisdiction is *not exclusive*

154 Liberté de l'Est, 28.11.1995, Credit immobilier: ".Selon Paul Lutz, l'avocat à Strasbourg, les problèmes viennent essentiellement d'une *manque de clarté*."; Klotz (1997), RIW, p.198

consumer protection on the other. At first glance one may find them surprisingly inconsistent and a rather paradoxical result of European harmonization measures. This inconsistency, however, may easily be explained by the different nature of these measures. In terms of "full faith and credit" the angle is very much different.

The Rome Convention contains a harmonized international private law applying within the EU *and* to relations with the outside world (Art. 2) [155], e.g. when a cross border transaction takes place from Germany to Poland. The principle of party autonomy is therefore weakened by important restrictions and reservations (mandatory rules, public policy). The Rome Convention in its present state can hardly be the specific international private law of a Single Market economy as it was never designed for this purpose.[156]

The Brussels Convention on the other hand specifically governs the rules as to international jurisdiction and recognition of judgments among the Member States. "Full faith and credit" is granted regarding international jurisdiction, e.g. the national courts are regarded as equivalent. There is no reservation based on public policy in that respect (Art. 28 §3 Bruxelles convention). This effect has become practical when the German courts have been stopped invoking the public policy clause in future transactions.[157] Recognition, however. is limited by the public policy clause. It is obvious that the difference is explained by the fact that the execution of foreign judgments interferes with internal affairs to a much greater extent.

One may say that the legal framework is far from supporting cross-border transactions. The inconsistencies largely are inherent to structural and fundamental conditions. Quick and smooth change is not likely.

This raises the question of how cross-border lending can be facilitated by extending the scope of Directive 87/102.

155 Kaye (1993),The New Private International Law of Contract of the European Community, p.34 :"*There is a natural temptation to assume that the Convention only applies where the law applicable thereunder would be that of another Contracting State. This would be incorrect*." Ebke, Erste Erfahrungen mit dem EG-Schuldvertragsübereinkommen in v.Bar (Hrsg.), Europäisches Gemeinschaftsrecht und Internationales Privatrecht, 1991, p. 77 (85)

156 Steindorff (1982), Termingeschäfte an ausländischen Börsen, IPRax 1982, p.49-51; Martiny (1991), in v.Bar, Europäisches Gemeinschaftsrecht und Internationales Privatrecht, p.229; Häuser/Welter (1985), WM-Beilage, p.1-16

157 Häuser/Welter (1985), WM-Beilage, p.1-16

C. Addressing Cross-Border Lending Directly

The essential question is how a Directive can be used to improve the inconsistent legal framework of cross-border lending. The study team considers it quite appropriate to take into account special conflict of law rules on cross-border lending. This technique as such would not be new as regards directives dealing with consumer protection issues. As a recent example, the Time Sharing Directive can be referred to.

Directive (94/47/EEC[158]) concerning Time-Sharing requires a conflict of law rule in Art. 9. The Member States have to ensure that the minimum protection will be realized if the object is situated in the Member States regardless of the applicable law[159]. Prominent authors point out that conflict of law rules in Directives should be developed with the following aims[160]:

1) ensuring the effect of the Single market against non-member States and
2) strengthening the Single Market in fields where harmonization has not been realized yet or where harmonization is not possible or appropriate and
3) strengthening the Single Market by ensuring that the Member States are willing to recognize the law of other Member States.This is achieved by rules granting the free choice of the applicable law.

In this case all three objectives would be addressed. The emphasis would be on the last two issues. As has been pointed out, a directive following the principle of minimum harmonization is not likely to remove all the distortions and create a highly competitive Single Market.

It would, however, be a first step: The respective level of harmonization and consumer protection could enhance the acceptability of products from abroad. This would fundamentally justify granting freedom to choose such a law as the applicable law. Additionally, the conflict of law rules could *specifically* take into account (individual) consumer interests and balance them against freedom of services (aspect of general welfare and thus general consumer protection). The Study Team envisions the following, incomplete, list of aspects:

- The various situations when concluding the contract will have to be distinguished (who takes the initiative to cross the border, i.e., who moves which direction, is the customer adressed in his country or going abroad physically or by internet). This approach is familiar as it corresponds to Art. 5 of the Rome Convention and its distinctions. At any rate this provision leaves room for the informed consumer taking the iniative to „shop abroad“.

158 Abl.1994 l 280,83
159 see for more details: Martinek (1994), ZEuP, p-470-492
160 Basedow (1996), NJW, p.1921-1929 (1927)

- As soon as mortgage loans are offered cross border, specific information and disclosure will be necessary ("labeling") to protect the consumer appropriately. The borrower should be fully aware that his loan is subject to foreign law, the disadvanteages of which he must balance against more favorable conditions. Standardization would support this approach.

D. Directive vs. Code of Conduct

While looking into the advisibility of a new directive on mortgage credit we should keep in mind the different legal instruments used on the European level to reach a minimum of consumer protection, in particular the directive (Art.189 III EEC) and the non binding recommendation (Art.189 V EEC) in contrast to a voluntary Code of Conduct. The second method provides an alternate path to legal harmonization, if binding harmonization by directives fails.

The directive as an instrument of European legislation under Art.189 III EEC has been approved many times and is the typical European instrument in the field of consumer protection. Directives are always addressed to the Member States and they are binding upon them as to the result to be achieved, while the determination of the form and means by which the result to be achieved remains within the competence of the Member States.

The idea of recommending a voluntary Code of Conduct which will lead to common banking ethics on mortgage lending shows that the lenders in Europe are willing to improve consumer protection in mortgage lending. The comparative study gives first hints whether a Code of Conduct is an advisible and effective approach to reach a minimum of Community harmonization with regard to mortgage credit. Four member states (The United Kingdom, The Netherlands, Italy, and Denmark) have already experienced positive results after introducing Codes of Conduct. The Netherlands have introduced a self-regulation system by which consumer protection has reached a high level. The Code of Conduct has the function of a law in the Netherlands. The structure of recommendation reflects the British tradition of self-regulation. It cannot be denied that a Code of Conduct System can have dynamic effects in the field of consumer protection. However, the disadvantage of a voluntary Code of Conduct is that lenders cannot be forced legally to adopt the rules of the Code. It seems to be doubtful if a European code of conduct can actually achieve the purpose of minimum harmonzation in the field of mortgage lending. Nevertheless, it may play an important role as a complement to a legally binding directive.

V. SUMMARY AND RECOMMENDATIONS

Although mortgage credit makes up empirically for the largest portion of consumer credit - the volume of outstanding mortgage loans is approximately four times the volume of outstanding non-real-estate consumer loans in the EU - it has been excluded from the ambit of the Consumer Credit Directive (CCD). Beyond political factors, the core reason for the differential treatment of both segments of consumer lending may be seen in the complex legal situation concerning mortgage credit in the Member States and in structural economic differences between the two loan types. For the most part there is a lack of specific and clearly defined law on mortgage lending which has resulted in mortgage credit provision being spread across case law, consumer law, general contractual law, banking law, and property law, to list a few examples. Economically, mortgage loans fundamentally differ from consumer loans due to their characteristics (in particular loan size, duration and dependence on collateral) and their refinancing techniques, with many national peculiarities. Also, the great variety of ancillary financial services which create the package character of mortgage lending and are typically absent with non-real-estate consumer loans complicate a mortgage credit directive.

One of the main objectives of the study has been to assess the feasibility and desireability of transposition of the CCD to mortgage lending. From a technical perspective, we have shown that the CCD has partially been transposed without major difficulty, in the cases of Ireland and Germany. Other countries have anticipated similar rules before the CCD has come into force (e.g., France). It is therefore in the opinion of the team feasible to transpose. However, in view of the economic complexity of the products simple transposition would not be particularly useful. In addition, other issues for mortgage lending that are routinely referred to in national consumer protection legislations or Codes of Conduct are missing.

At issue for the team was whether a set of simple standardizations in the identified areas could be found that further the twin goals of providing the basis for a Single Market and a sufficient standard of consumer protection in the Member States. The team evaluates three options for EU action:

Status Quo: Consumer protection standards for mortgage lending in the Member States widely meet or exceed the minimal requirements of the Consumer Credit Directive (with the notable exception of early repayment). However, little cross-border lending takes place under the status quo denying consumers the welfare-enhancing benefits of increased competition. This situation is due to a complex set of reasons including the use of consumer protection measures to block particular products or practices that can be used by cross-border competitors. As a result, cross-border lending is less likely to improve after enactment of the EMU. In the long run, decisions of the European court concerning freedom of services may create more favorable conditions. Another remedy could be seen in the attempts to define more clearly the “general good“ according to the Second Banking Directive. The first alternative is hardly predictable and the study team doubts that the latter will really improve the situation as this does not effectively address the conflict of law problems involved

Code of Conduct: The Code of Conduct approach offers some promise in developing Europe-wide consumer protection standards for mortgage lending. Looking at the reference models, a Code of Conduct would most likely produce standards of counseling and disclosure. Its strength would be its flexibility and dynamism; its development is consensual and it can be more readily modified to accommodate changes in technology and market practice than a Directive or national legislation. Its primary limitation is that it is not legally binding. A further difficulty is that it is difficult to include all providers of mortgage credit. Early experience with a Code of Conduct in Denmark and Netherlands, nevertheless, is promising. Short of promulgating a Mortgage Directive, the Commission should encourage lending organizations to work with consumer groups in the Member States to pass Codes of Conduct. Furthermore, efforts should be made to standardize such codes in order to facilitate increased cross border lending. The team recognizes the difficulty of this approach, however, as several member states have consumer protection legislation significantly in excess of the requirements of existing Codes.

Transposition of Consumer Credit Directive/Mortgage Credit Directive. The study team reviewed the elements of the Consumer Credit Directive to assess the likely impact a transposition would have in furthering the aforementioned goals. It is our view that the Directive could be transposed to mortgage credit without restricting the full choice of products to the consumer. The CCD can be modified so as to make it more effectively address mortgage lending. These changes are quite substantial and in effect constitute a Mortgage Credit Directive:

- Article 4 and Annex I: Advertisement, counselling and information disclosure requirements need to be modified and enhanced in the case of mortgage lending. Benchmarks for such requirements have been detailed in Chapter III. They could be evaluated in a European Code of Conduct. Information requirements could be captured in a single-page information sheet.

- Article 4 in conjunction with the pending Directive 90/88: Requiring a uniform calculation method for APRC for the case of mortgage lending is a useful tool; considering the state of the discussion of Directive 90/88 a transposition appears feasible. However, a calculation standard cannot stand alone, as the study team has shown, since it cannot capture the extreme diversity of mortgage products. In order to make adequate comparisons the consumer would have to be guided by grouping/labelling of products. Existing forms of treatment of variable rate instruments and the assumption that all loans are held to maturity would similarly have to be addressed. Furthermore, national and productspecific differences over which ancillary services are mandatory, public or private, forbid a European uniform standard beyond a minimum set of cost factors.

- Article 7, is regarded as irrelevant for a Mortgage Credit Directive.

- Article 8, giving the universal right to discharge with an equitable reduction in the total cost of the credit, is a very simply structured provision that is insufficient to cover the sophisticated techniques and the product variety which are characteristic for mortgage lending. At the present stage, a mere technical transposition would eliminate a major contract type offered in the EU and create significant adjustment costs for a major refinancing method (the Pfandbrief). The present status of case law in Germany has, however, rendered a transposition of Article 8 more feasible. Irrespective of this particular case, the study team recommends that necessary amendments to the existing text be adopted:

  - Amendment 1: The lender shall be entitled to a maximum compensation payment up to the sum of additional costs he incurs through early repayment. For the definition of the maximum compensation payments, the study team alludes to the ongoing discussion in Sweden, The Netherlands, Finland, and Germany; the present status of the discussion forbids further detail in a European Directive, but may leave the details (for an interim period) to subsidiary law-making.

  - Amendment 2: The compensation payment shall cover a maximum interest-rate fixing period up to a maximum period (say, 10 years). With the exception of the UK, all European countries implicitly or explicitly cap the size of prepayment penalties.

- Article 9 regulating assignment follows national laws, taking the lenient approach of protecting only the defences that the borrower would have with *any* lender. Regulating the substance of assignment in a Mortgage Credit Directive, e.g, through making it mandatory to seek the borrowers' consent, could interfere into basic property rights and impair important mortgage refinancing techniques, such as securitization. Being aware of the strong overlappings of the issue with other spheres of consumer protection, such as bank secrecy and data protection, the study team recommends no changes of the CCD formulation.

We furthermore recommend to remove the ambiguity of the legal ambit definitions (Article 1 and 2) in order to make sure that only loans used for the finance of owner-occupied housing fall under the directive.

Going beyond the scope of the Consumer Credit Directive the subjects of rate adjustment, portability and assumability are relevant. The study team has come to the following conclusions:

- A Mortgage Credit Directive should include an additional Article covering the adjustment of financial conditions of mortgage contracts, most notably, adjustable-rate mortgages. The Article could require the linking of changes in the nominal contract rate to changes in an interest-rate index; however it should be possible that such an index be constructed by the lender himself, as long as it is regularly published. The lender should make the history of the index accessible to the consumer before underwriting. Other conditions than the nominal interest rate should be required to remain constant.

- The study team does not propose a European regulation for portability. Information about portability conditions should, however, be compulsory for the loan agreement (Article 4).

- A Mortgage Credit Directive should not address explicitly assumability other than imposing information requirements (Article 4). The simple fact that characteristics inherent in the mortgage collateral make a transfer impossible in some countries, forbid a European regulation. Regulating early repayment is the more powerful consumer protection tool.

Even a modified CCD, embodying the principle of minimum harmonization, is in view of the study team unlikely to have a major effect on cross-border lending by itself. One of the main reasons is the uncertainties lenders experience in attempting to sell their products abroad without being in conflict with national rules on consumer protection in the host country. Therefore, the team suggests to address cross-border lending directly, by introducing a conflict of law rule along the lines discussed in Chapter V (Article 15). Under appropriate standards of protection being guaranteed by a Directive harmonizing the law of mortgage lending the lenders could be allowed to choose the law of the Member States, without the restrictions and incertainties existing at present, provided that the customer is fully aware that he is not acting under the legal system of his home country.

Total harmonization as an alternative to the proposed strategy would raise the question which level of protection could be agreed upon on the EU level. Following models offering higher protection than what the study team identified in Chapter III would jeopardize existing contracts. A lower level, on the other hand, would invoke the opposition of Member States offering higher standards of protection.

Given these trade-offs, what role can the Commission play? A Code of Conduct approach could be a promising start to provide for a common minimum standard of consumer protection, but if that effort turns out to be inadequate to cover the relevant issues (see Chapter III) the Commission could consider a Mortgage Directive along the lines discussed.

Creating minimum standards could mean some improvement for cross-border lending, but one cannot expect that this alone will be sufficient to generate truly single-market conditions. That will only come with increased competition and product offerings in the Member States. In order to address the key issue that higher levels of protection may be used to block cross-border competition, a conflict of law rule appears the most feasible solutions: it maintains higher levels of consumer protection for those Member States whose citizens demand such protection while opening up markets to increased cross-border competition.

PART 2

National Reports on Consumer Protection Regulations

In order to get a picture of the existing measures for consumer protection in the Member States the study will in a first step have to analyse the extent to which Member States have transposed the Directives 87/102 and 90/88 to mortgage lending. Beyond that, the protection of the mortgage borrower will be examined as it is ensured by various types of regulations whic h are not necessarily linked to the implementation of the Directive or even clearly lie beyond its scope, e.g., with respect to the various issues discussed above. Even regarding the content of the Directive itself, it would be superficial or even misleading to measure consumer protection merely by the extent to which Member States have transposed the Directive 87/102/EEC to mortgage lending. Quite independently from the Directive the relevant issues may be dealt with by legislation, regulations or case law based on various legal aspects.

In view of the diversity of the systems and the large number of legal systems involved, it was not envisaged to draw up a complete comparative legal study. The aim was to give a general idea of the level of protection applicable in the respective Member States and to present the essential protective measures. In order to facilitate comparisons, a survey was launched to uniformly gather data by a questionnaire. The replies were to reflect the existing rules and practices regarding the mortgage loan contract.

A. Austria

1. Transposition

The Consumer Credit Directives 87/102 and 90/88 have been transposed into the Austrian Law by the Banking Activities Act[161], the Consumer Protection Act[162], and a decision of the Federal Ministry for Economic Affairs concerning consumer credit[163]. The provisions §§ 33 - 35 of the Banking Activities Act are not only applicable to consumer credit contracts, but also to mortgage lending contracts.

161 Bundesgesetz über das Bankwesen, BGBl 532/1993, entered into force the 1.1.1994

162 Konsumentenschutzgesetz, entered into force the 8.März 1979,BGBl. Nr.140, amended in 1993, BGBl Nr. 287

163 Entscheidung des Wirtschaftsministeriums betreffend Verbraucherkreditverträgen, BGBl Nr. 365

2. Issues Regulated

a) Advertisement and Disclosure

Under § 35 II BWG, any advertisement mentioning any interest rate must contain a statement of the APRC.

The rules concerning disclosure are fully applicable to the mortgage lending contract. The written credit contract must include some specific information as specified in § 33 II BWG about:

- the total amount of cost,
- the APRC,
- the interest rate in respect of arrears,
- the number, amount and time of repayment installments[164].

In the case of the non-fulfillment of the disclosure duty the Austrian law does not provide any civil consequences[165].

b) Cooling-Off-Period

In the Austrian legislation we cannot find a cooling-off-period in the field of mortgage lending.

c) APRC

The definition and the calculation formula of the annual percentage rate of charge is given in § 33 IV BWG.

d) Early Repayment

The Austrian legislation provides a differentiated solution in the question of early repayment. The consumer is entitled to repay the loan early under § 33 VIII BWG, but a compensation can be agreed in the mortgage lending contract[166] and the consumer must inform the creditor of his intention to repay ahead of schedule within a time limit set out in the credit agreement. In the case of a loan agreed for minimum ten years, the parties can provide in the credit contract that the consumer is able to repay after

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164 Bollenberger (1996), ,p. 29

165 Graf (1994), Österreichisches Bankarchiv, p.4-18

166 Bollenberger (1996), p.29

six months´notice. In the case of a fixed rate loan it is admissible to exclude the right to repay the loan early during a fixed rate period.

§ 18 of the Mortgage Banking Law[167] does not regulate especially the consumer credit contract, but it contains a provision about early repayment. Under §18 of the Mortgage Banking Law, the debtor is entitled to repay the loan early, but this right can be excluded for ten years.

e) Assignment

In the Austrian Civil Code general rules are laid down covering assignment in §§ 1392 to 1399 ABGB. In order to assign a loan secured by a mortgage the assignment must be inscribed in the land registry. The debtor is entitled to plead the same defenses against the new creditor under § 1396 S.1 ABGB[168].

f) Adjustment

In the case of loans with variable interest rates an adjustment is allowed, if the conditions for the adjustment are explained in the loan contract and if the adjustment does not only depend on the lender's discretion, but on objective criteria[169].

B. Belgium

1. Transposition

The Consumer Credit Directive 87/102 has been transposed in Belgium into the Consumer Credit Act, which entered into force the 12 June 1991[170]. Under Art 3 §1 No.7 of the Consumer Credit Act, mortgage lending contracts are excluded. Mortgage lending contracts fall under the scope of the Mortgage Lending Act[171], entered into force January 1, 1993.

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167 Hypothekenbankgesetz, in: Österreichisches Bank- und Börse-Recht,edited by Haschek, Braumann, Doralt, Csoklich, 3.Auflage, Wien 1994

168 see for more details: Jud (1986), p.267

169 Response to the questionnaire of the study-team by Verband der Österreichischen Landes-Hypothekenbanken, Wien 07/04/97, p.6

170 published in the Moniteur Belge of 9/07/1991,p.15203 ff.

171 Loi relative au crédit hypothécaire de 4/08/92, Moniteur Belge, 19/8/1992

2. Issues Regulated

a) Advertisement and Disclosure

Art. 47 of the Mortgage Lending Act provides that the lender should make information booklets and brochures available to the consumer. If an advertisement mentions any interest rate, the advertisement must also include the APRC[172].

In the written offer the lender must announce all the contract conditions and the period of validity of the offer (Art. 14 of the Mortgage Lending Contract). This provision allows the consumer to compare different offers of mortgage lenders[173].

b) Cooling-Off-Period

The law in Belgium does not provide a cooling-off-period.

c) APRC

In the field of APRC the Consumer Credit Directives 87/102 and 90/88 have not been transposed concerning mortgage lending. The Mortgage Lending Act 4.8.1992 defines the interest rate in Art.4 No 4 as "étant le taux, exprimé en pourcentage, par periode, auquel les interêts sont calculés pour la meme periode". The calculation formula is included in Art.10 of the royal Arreté (5.2.1993)[174]

There is no obligation to include all the costs in the calculation of the APRC, as it is provided for consumer credits[175].

d) Early Repayment

The borrower is, under Art.26 of the Mortgage Lending Act, allowed to repay the loan at any time for regulated loans. Any provision to the contrary cannot preclude partial repayment once a year or the repayment of an amount equal to at least 10% of the capital. In the event of voluntary total or partial

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172 Arreté royal portant diverses dispositions d´execution de la loi du 4/8/1992 relative au crédit hypothécaire; Art.12 Belgish Staatsblad, 24/2/1993

173 Budget & Droits (1992), No.106, p. 43

174 Arreté royale, 5.2.1993, Belgish Staatsblad: p.93 - 433, 24.2.1993

175 Budget & Droits (1994), No 118, p.40

early repayment, borrowers will have to pay the mortgage lender compensation equal to three months' interest, calculated at the rate of the loan, on the capital repaid in advance. Three months' interest is a maximum (Art 12 of Act 4.8.1992)[176].

No compensation is payable in the case of repayment following death, under an annexed life assurance contract.(Act of 4.8.1992, article 12).

e) Adjustment

Under Art. 15 of the Act 4.8.1992, it is prohibited to change the contract conditions unilaterally. However, Art. 9 § 1, 3° of the law provides for special rules concerning the adjustment of interest rates. If an adjustment takes place, it must refer to an indexation presented by the Council of Ministers[177].

f) Assignment

An assignment is valid without consent of the mortgagor. Art.1690 of the Civil Code provides that the assignment must be notified to the mortgagor. In addition, the assignment of a mortgage must be written down in the public registry book[178].

The borrower retains all his defenses against the transferee[179].

g) Assumability

Belgian law does not provide for assumability in the case of the mortgaged house being sold.

Credit contracts generally even contain a clause requiring the consent of the lender if the borrowers wants to sell the mortgaged house. The consent is given if the borrower offers another house to be mortgaged or if the loan is repaid from the proceeds of the sale.

h) Other Protection Measures

The consumer should have the free choice of assurances[180], if the lender is imposing them.

176 Reich (1997), Bankrechtstag, p.54

177 „La variation du taux d´interêt doit être liée aux fluctuations d´und indice de référence.“ (art.9 § 1 3°)

178 Bernstdorff (1997), RIW, p.181-188 (182); Loncourt (1994), p.31

179 Loncourt (1994), p. 46

The use of general terms regarding loan contracts must be permitted by the Belgian authorities[181].

In case of default the lender is allowed to address the court to be granted grace periods under Art.59 of the Mortgage Lending Act or under § 1244 of the Civil Code. Beyond that Belgian law does not provide for rules regarding overindebtedness in general.

C. Denmark

1. Transposition

The Directives 87/102 and 90/88 have been implemented in Danish legislation in the Danish Credit Agreement Act[182], which entered into force on 1 January 1991. The regulations in the Act, which prescribes the lender to state the APRC of the loan came into force on 1 January 1993.

Mortgage credit loans fall under the scope of the Act (§ 1). Beyond that the Code of Conduct applying to all Danish mortgage banks has to be taken into account. It came into force as of 1 June 1996.

2. Issues Regulated

a) Advertisements and Disclosure

The Act on Marketing prohibits the use of incorrect or misleading statements which are meant to influence the mortgagor. The compliance with the Act is supervised by the Danish Consumer Ombudsman.

Art. 8 of the Danish Mortgage Credit Act provides that any loan offer from a mortgage bank must be accompanied by information about the APRC, the amount of credit advanced, the period of agreement, the total costs of the loan, total amount repayable, and the number of repayment installments[183].

Under the Code of Conduct the loan agreement must provide information on the conditions under which assumability may come into effect. As regards information on the price of the loan the Code of Conduct

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180 Budget & Droits (1992), No 106, p. 43

181 The Belgian Banking Commission is entitled to control the contractual frame under the Royal Decret No. 225 of 7.1.1936 about mortgage lending

182 in Danish :Kredit Aftalelov, published in Lovtidende 13/06/90

183 Iversen (1994), p. 80

goes beyond the requirements of Art. 8 of the Danish Mortgage Credit Act including information about possible comparative prices.

b) Cooling-Off-Period

In the Danish mortgage credit system there is no cooling-off-period.

c) APRC

The general disclosure obligation includes the regulations concerning the calculation of the APRC. An indication of an APRC is required in the Danish Credit Agreement Act.

d) Early Repayment

Early repayment of a mortgage loan is always possible, if the borrower purchases and surrenders to the mortgage bank an adequate amount of bonds listed under the same securities code, i.e., with the same maturity, nominal interest and repayment profile as the bonds originally used to finance the loan. The borrower may either purchase the bonds himself and surrender them to the mortgage bank or accept the mortgage bank's offer to purchase bonds on his behalf against payment of the market price (redemption through delivery of bonds, „delivery option"). Details are discussed in Chapter III.

This option of repayment at par can be exercised at any point of the term of the loan. However, before this can take place, the termination of the loan must have been announced at minimum two months notice prior to one of the annual settling periods for the loan (normally 4 settling periods per year). The borrower may also repay prematurely "in cash", adding a so-called difference interest for the period from the repayment to the settling period.

For the administrative handling of the repayment a small fee is charged (typically 200 DKK). In the case of repaying with bonds a commission has to be paid. The borrower is not burdened with prepayment penalties.

e) Assignment

According to statutory law the mortgage lender has the right to assign the mortgage contract without the consent of the borrower. The lender keeps all his defences against the new lender[184]. In practice, however, mortgage deeds issued by the borrower to the mortgage bank are provided with a so-called non-transferable clause. According to this clause the morgage deed and the mortgage claim cannot be transferred either for ownership or as security. The non-transferability can be seen as a standard within the Danish mortgage bank system.

f) Assumability

According to the mortgage deed the mortgage loan becomes payable if the mortgaged house is sold. It is, however, normal practice that lenders grant assumption of a debt, if this is desired by the new owner. According to the Code of Conduct of the mortgage banks the loan agreement has to contain information about the criteria on which the request of taking over a debt is assessed.

g) Other Protection Measures

(1) Default Situation

Section 42 a of the Danish Land Registration Act lays down the procedure to be followed by the mortgagee if the mortgagor is in default. In a default situation the creditor can demand the capital to be redeemed, if the debtor has not paid interests and repayments no later than seven days after written demand has been put forward[185]. This may happen after the due date and the demand shall explicitly state that the capital can be claimed redeemed, if interests and repayments are not paid within the time limit given. The lender can demand interest in arrears only if 7 days have elapsed after the due date.

(2) Counseling Duties

Whereas Danish law does not provide counseling duties of the mortgage lender, the Code of Conduct contains a provision on counseling. Under Art.5.2 of the Code the counseling shall be of high professional standard and shall consider the consumer's interests.

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184 Iversen (1994), p.72

185 Section 2 of the standard mortgage deed formula

(3) Overindebtedness

The Danish Act on Bankruptcy contains some general provisions concerning rescheduling of the debt and composition schemes. The provisions are aimed at providing remedies via judicial procedures.

If a debtor requests, the Probate Court (part of the Local Court) may order a rescheduling of his debt. The order of the Court is based on an assessment which can be influenced by the creditor's comments on the debtor's proposal. The order may reduce the claims by a certain percentage. However, the mortgage itself is not affected by a rescheduling of debt. Mortgage banks are only affected when the property is sold at an auction and the mortgage bank keeps an unsettled claim which becomes a personal claim against the former owner. This claim would then be affected by rescheduling.

Similar results are connected with so called composition schemes. According to the Danish Bankruptcy Law a statutory majority of creditors may force the rest of the creditors to accept an arrangement according to which the debtor obtains a reduction of the debt to avoid bankruptcy. As a principal rule this does not affect mortgagees. Only when the property is sold will it be stated whether a part of the mortgage bank's claim is unsettled. Only an unsettled claim will be reduced to the dividend stated in the composition scheme.

D. Finland

1. Transposition

In Finland the Consumer Protection Act No. 38/1978[186] is applicable, which deals with consumer credit in its Chapter 7. This statute was amended on 8 January 1993 with a view to transposing the Consumer Credit Directive 87/102. In many respects, however, it goes farther in protecting consumers' interests. The scope of Finnish legislation is far wider than that of the Directive as it covers mortgage lending. (Chapter 7, section 1 §3). All rules are mandatory[187].

186 Translated: „kuluttajansuojalaki"

187 Chapter 7 § 20 of the Consumer Protection Act

2. Issues Regulated

a) Advertisement and Disclosure

The aim of the Finnish Consumer Credit Act is to guarantee a high standard of consumer protection by transparency[188]. The APRC should be disclosed in any marketing measures, especially in advertisements stating a loan's nominal interest rate (Chapter 7 section 6). The lenders in Finland are obliged to inform the consumer about the costs of the credit. The written contract must contain the amount of the credit, the interest rate and other costs of the credit, the number of the repayment installments, all the contract conditions and the APRC (Chapter 7 section 11). The lender is not entitled to demand costs which are not explicitly mentioned in the written contract (Chapter 7 section 10 §2).

b) APRC

The regulations on the APRC took effect through decisions by the Ministry of Trade and Industry in 1986 and 1994. Calculation formula do not completely match the regulations of the directives 87/102 and 90/88.

c) Early Repayment

Under Chapter 7 section 12 of the Finnish Consumer Credit Act, the consumer has the right to pay the consumer credit before it matures. The creditor may charge a compensation for early repayment of the credit if the interest rate on the credit is fixed or if the period for the determination of the reference interest rate is at least three years and if the interest rate of a corresponding new credit offered by the same creditor is lower than the rate agreed upon[189]. The maximum compensation is the difference between the interest agreed upon and the corresponding credit with fixed interest for the remaining period or the period for the determination of the reference interest rate.

d) Adjustment

The consumer is protected from unfair adjustments of interest rates by section 11. The terms of a consumer credit agreement may stipulate that the interest rate payable on the credit shall vary in accordance with the basic rate of interest charged by the bank of Finland or other reference interest

188 Mäntysaari (1996), chapter 6.3.

rate detailed in the agreement. This reference interest rate, however, shall be published and based on matters not dependent on the creditor's discretion alone. The consumer shall be notified of changes in the interest rate in writing.

e) Default Situation

Section 16 protects the borrower from undue burden as a consequence of his default situation. The creditor may only enforce his contractual right to claim an installment that has not otherwise matured if the payment has been delayed by at least one month and if the amount exceeds certain limits. More important, however, the creditor according to section 16 § 2 shall not have the right to enforce this sanction if the delay and payment is due to the consumer's illness, unemployment, or other corresponding reasons that are not dependent on him[190]. This borrower's protection is limited by the rule that takes into account the length of the delay and other circumstances that would be clearly unreasonable for the creditor.

If the creditor may claim installments that would not have otherwise matured the lender's claim is reduced according to the rules applicable to early repayment (section 12). Maturity may not become effective earlier than four weeks from the date on which the notice of maturity was given or sent to the consumer.

f) Other Protective Measures

Finnish law provides that the Council of State may take measures designed to prevent overindebtedness of consumers. This, however, seems to be designed for consumer credit outside mortgage lending.

A Court procedure for debt rescheduling of overindebted persons is provided for in the law 57/93. This law is applicable if a private person is not able to repay his debts in the event that his financial situation will not be improved in the near future. In addition to that, overindebtedness must be caused by social circumstances which are not dependent on the debtor, e.g., unemployment, illness. The claim of the lender cannot be reduced under Finnish law. However, it is possible for courts to grant a prolongation of the time-frame to repay the loan[191].

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189 Wenzel (1996), WM, p. 1605 (1607)

190 Reich (1997), p.55

191 See for more details: Koskelo (1995), ZEuP, p.622-632 (627)

E. France

1. Transposition

France provides an example of a consumer protection law which is conceived systematically and goes far in substance[192]. French law had to introduce only minor amendments[193] in order to transpose the EC-Directives 87/102 and 90/88[194] (so called passive transposition). The protection of consumers in the field of mortgage lending is regulated in the law of 13 July 1979 - the so called "loi Scrivener II"-, which entered into force the 1st July 1980. This law is now incorporated in the Consumer Protection Code of July 26, 1993[195], which resulted from melting together the existing laws on protection of consumers[196].The Code is divided into five parts[197] and the third part contains provisions in Chapter I concerning mortgage lending contracts.

2. Issues Regulated

a) Advertisement and Disclosure

French law contains detailed provisions concerning the content of advertising in the field of mortgage lending (Art.L.312-4 à L.312-6).The advertisement, written in French language only[198], must include specific information about the identity of the lender and the nature of the loan. In case an advertisement mentions any interest rates, the advertisement must include the total costs and the APRC. It is illegal to compare repayments under the loans with rents becoming due in the case of renting a dwelling (Art.L.312-6).

As far as the contract itself is concerned, the offer plays a crucial role. Under Art.L.312-8, in the written offer, which must be sent by mail, the lender must incorporate the information given in the

192 Klotz (1997), RIW, p.197-201; Hahn (1994), RIW, p.114-117 (115)

193 Only Art.8 concerning early repayment required a statutory amendment.

194 Pizzio (1996), p.327

195 Loi No.93-949 du 26 juillet 1993 relative au code de la consommation (Partie legislative), Journal officiel (J.O.), Lois et Décrets, 1993, S.10538 ff.

196 Calais-Auloy/Steinmetz (1996), p.28; Witz/Wolter (1995), ZEuP, S.35

197 Livre I: Information des consommateurs et formation des contrats
Livre II: Conformité et securité des produits et des services
Livre III: Endettement
Livre IV: les associations des consommateurs
Livre V: Les institutions

198 Art 2 de la LOI TOUBON concerning the protection of the French language, 4.8.1994;

advertisement and more personalized information: identity of the borrower and the lender, nature and specific conditions of the loan, total cost of the credit, APRC, the index if the loan is agreed with adjustable rates, assurances[199] , information about a possible transfer of the loan, and period of validity of the offer (minimum 30 days). Going even beyond these requirements the French "Cour de cassation" has held, that the lender has to indicate for each installment, to what extent it covers interest and repayment of the loan[200]. Furthermore, case law requires an indication of the calculation of payable interest rates in the event of early repayment[201].

b) Cooling-Off Period

Instead of granting a right of cancellation to the consumer, as it is introduced for consumer credits[202], the loi Scrivener II has introduced another protective measure, the so called period of reflection, which predates the conclusion of the contract[203]. The offer is binding for 30 days at least, whereas the borrower is not allowed to accept the offer before ten days have elapsed (Art.L. 312-10). After the borrower has accepted there is no further cooling-off period.

c) APRC

Art.L. 313-1 of the Consumer Protection Code provides the elements which must be included in the APRC: all costs, including notary and registration fees. This is mandatory as far as the contract itself is concerned. As regards advertisements and the preliminary offer, certain costs such as fees may be left out if their amount cannot be determined (Art. Art.L. 313-1 al. 2). The calculation formula is laid down in Art.R.313-2 [204], which follows the so calle d proportional method. The Directive 90/88 providing for a different calculation has not yet been transposed into French law[205]. If the rules on the APRC are not respected, lenders face penalties (2.000 to 30.000 F). According to case law the agreement on in terests are void (reduction to 0)[206].

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199 Le Code de la Consommation, (1996), L.Art.312-11

200 Cass. civ. 1 re, 20.july 1994, Bulletin civ., I,No.262; Pizzio (1996), Art.L.312.7, 9

201 Cass.civ.1re - 30.3.1994, D.1994.IP.102, Reich (1997), p.54

202 Art.7 of the loi Scrivener I, Art.L.121-25 Code de la Consommation

203 Witz (1994), p.280

204 Journal Officiel du 3 avril 1997, Lois et Décrets, Code de la Consommation, Partie Réglementaire, Annexe au décret n° 97-298 du 27 mars 1997 relatif au code de la consommation

205 Pizzio (1996), Art.313-3, 3, In principle the calculation method should have been amended until the end of 1995.

206 Cass.civ.1re, 24 juin 1981, J.C.P.,1982, II, 191713, note Vasseur; Cass.civ.,1re, 9 février 1988, Bull.civ., I, n°34, Pizzio (1996), p.349

d) Early Repayment

The question of early repayment is regulated in Art.L.312-21 et R.312-2 of the Consumer Protection Code. The borrower is entitled to repay his loan at any time[207].

The contract may prohibit an early repayment not exceeding 10% of the original loan amount. In the event of early repayment, the lender may claim a contractually determined compensation equal to interests of one semester, calculated at the rate of the loan, on the capital repaid in advance. This compensation, however, may not exceed 3% of the outstanding loan[208].

Under Art.1152 of the Civil Code, the judge can reduce the compensation if it is excessive in the individual case[209].

e) Adjustment

In the case of adjustable rate mortgages the offer must indicate the modalities of an indexation under Art.L 312-8 3° of the Consumer Protection Code. The adjustment must follow the conditions laid down in the credit agreement.

f) Assignment

An assignment is valid without a general consent of the mortgagor. Under Art.1690 of the Civil Code, however, the assignment must be formally[210] notified to the mortgagor (signification). The debtor keeps all his rights and can plead the same defenses against the new creditor.

g) Other Protection Measures

(1) Criminal Penalties (Art.L.312-32 - Art.L.312-35)

The Consumer Protection Code provides sanctions,which can be considerable criminal penalties, for breach of the statutory rules.

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207 Art.L312-21 : 1) L´emprunteur peut toujours, à son initiative, rembourser par anticipation, enpartie ou en totalité, les prêts régis par les sections I à III du présent chapitre. le contrat de prêt peut interdire les remboursements égaux ou inférieurs à 10% du montant initial du prêt, dauf sil agit de son solde.

208 Art.2 du décret No.80-473 du 28 juin 1980 dans le domaine immobilier, Reich (1997), p.54

209 Steinmetz (1994), Hebdo, No. 845, p.9; Reich (1997), p.54

(2) Usury (Art. L.313-3)

Usury is defined in Art.L. 313-3 by rates exceeding the medium rate applied in the last trimester by 30%. The consequence of usury is not that the credit contract is null and void, but the borrower is entitled to claim the money which the lender has received illegally (Art.L.313.4). The law provides for criminal sanctions.

(3) Grace Periods in Case of Default (Art. L.313-12)

In case of default the borrower is entitled to address the court in order to be granted grace periods provided under Art.1244-1 -1244-3 of the Civil Code. The court may reduce the interest rate to zero and the contractual obligations may be modified[211].The contract period may be extended by two years.

(4) Procedure Applied in the Case of Overindebtedness (Art. L.331 et seq.)

The "Loi Neiertz[212]" entered into force on 31 December 1989 and has become the third part of the Consumer Protection Code. The French legislature introduced this law to prevent private persons from overindebtedness and it contains detailed provisions to regulate these cases. The rules are applicable if the non-commercial debtor, acting and having acted in good faith, is now obviously unable to repay his debts[213]. The courts had to interpret the rather complex term "debtor in good faith", leading to considerable controversy[214].

The French legislature has introduced a 2-step-procedure: a voluntary arrangement before a commission[215] (phase aimable) and a decision by a court (phase judiciaire). Several measures can be taken, such as the reduction of interest rates, introduction of grace periods, and under certain circumstances even reduction of the claim. It is important to note that the lender can even totally lose his remaining claim against the debtor if the house is sold within one year and the debt is not covered by the

210 By a sheriff (huissier)

211 Pizzio (1996), Art.312-12, No.3

212 published in Journal Officiel of 2.1.1990, Mme Neiertz was at the time secretary of the state in the field of consumer protection (secrétaire d´Etat à la consommation) and has initiated the law.

213 Impossibilité manifeste pour le débiteur de bonne foi de faire face à l´ensemble de ses dettes non professionelles exigibles at à échoir (Art.L.331-2)

214 For more detail see: Ferrand (1995), ZEuP, p.600-616 (603)

215 The commission (commission départementale de traitement des situations de surendettement) is composed of 5 members: a representative of the Bank of France, a representative of the financial administration, a representative of credit institutions, a representative of consumer protection associations and the „Präfekt" (Art.L.331-1)

proceeds (Art.L. 331-7 IV)[216]. According to this rule the responsibility to determine the value of the house to some extent lies with the lender.

The rules governing overindebtedness are part of the French "ordre public"[217].

(5) Bills of Exchange (Art.L.313-13)

Art. L. 313-13 deals with the customer's signing bills of exchange. The law provides that the consumer signing a bill of exchange is treated like a minor, making the obligation under the bill void (Art.114 Commercial Code). This regulation has to be understood as the implementation of Art.10 of the Consumer Credit Directive 87/102, but extending it to mortgage lending. In its consequences it goes far beyond the implementation in other Member States which leave the obligation as such untouched.

(6) Linked Contracts (Art.L.312-12 à L.312-20):

In French law there is a remarkable interdependence between the financed and the financing contract and vice versa.

The financed contract, e.g., a contract related to the sale of a house, must indicate whether the consumer is going to fulfill his contractual obligation with or without a mortgage credit agreement. The conclusion of the credit contract is considered as a suspensive condition for the principal contract. If financing fails within one month after having agreed, the principal contract it is considered void (Art.L.312-16).

The problem in this respect seems to be the interpretation of "getting a loan"[218]. On one hand, the condition of "getting a loan" could be fulfilled by receiving the loan offer[219], on the other hand, only by accepting the loan offer[220]. A strong argument against the interpretation of letting a loan offer suffice is a systematic one, this interpretation is not consistent with the provision that the borrower is not allowed to accept the offer before ten days have elapsed. It is stated, however, that the borrower must have

216 Le Code de la Consommation, Edition commentée, Paris 1996, p.259; „une remise totale de la dette est possible si cette mesure est seule compatible avec les ressources du débiteur", Cass.Civ.,17 mai 1993, INC no 2924; Ferrand (1995), p.600-616 (614)

217 Cass., 16 décembre 1994, avis no 28, Bull.inf.cass.15 février 1995 p.1

218 „..cet acte est conclu sous la condition suspensive de l´obtention du ou des prets qui en assument le financement." Art.l. 312-16., see for more detail: Witz (1994), p.282

219 Auloy/Steinmetz (1996), No. 381

220 Code de la Consommation (1996), Prat editions, Art.L. 312-20

legitimate reasons for not accepting the offer[221]. Otherwise it would be left to his discretion to let financing fail in order to get out of the principal contract without any disadvantages for him.

On the other hand, under Art. L.312-12 the loan offer is accepted under the resolutory condition of the conclusion of the principal contract[222]. Therefore, the consumer avoids being bound by a loan contract which is useless for him[223]. If the principal contract fails to come about within four months the borrower has to reimburse all moneys received from the lender. A service charge can be imposed not exceeding the amount provided in a public list (Art.L.312-14)[224].

In the case of more than one loan agreement financing the same operation, each loan contract is agreed under a suspensive condition. If one financing contract fails all the other loans financing the same operation will not effective under Art.L.312-13. These rules only come into play if the borrower informs the lender about the necessity of several loans to finance the project in advance and if the loan amounts to more than 10% of the total sum of the credit[225].

If the loans serve to finance construction contracts which become subject to a court trial the court may suspend the execution of the loan contract. The Cour de Cassation has considerably extended this protection by judging loan contracts void if the financed contracted is void or resolved.[226]

F. Germany

1. Transposition

The Directives 87/102 and 90/88 on consumer credits have been transposed into the German Consumer Credit Act[227] and into the German Price Disclosure Regulation[228]. Quite remarkably, the first legislative proposal of the German Government, which has never entered into force, excluded mortgage lending

221 Code de la Consommation (1996), Prat editions, Art.L.312-20

222 This principal contract is usually a contract of solde, of construction or restauration of a building.

223 Auloy/Steinmetz (1996), p.382

224 A reglementation provides the maximum amount of the service charge which can be 0,75% of the principal sum of the loan not exceeding 1000 F.(Décret du 28 juin 1980)

225 Auloy/Steinmetz (1996), p.385

226 Pizzio (1996), p. 339

227 Gesetz über Verbraucherkredite, Zur Änderung der Zivilprozeßordnung und anderer Gesetze of 17/12/90 - BGBl 1990 I ,p.2840, The Act recodifies the Hire Purchase Act (Abzahlungsgesetz) as well as the case law of the Federal Supreme Courton individual aspects of consumer protection in the loan contract.

228 Erste Verordnung zur Änderung der Preisangabenverordnung of 03/04/92 - BGBl 1992 I, p.846 of 10/04/92

altogether[229]. The proposed provisions were considered not to be suitable for mortgage lending contracts. However, following an intervention of the Federal Council the proposal was amended to include mortgage lending. This proposal eventually became law as it was seen in line with the rationale of the Directive on the protection of consumers[230]. Thus, contrary to the EC-Directive, the German Consumer Credit Act in principle applies to credits secured by mortgages as well. However, the applicability is essentially confined to the provisions regarding formal requirements[231]. It should not be overlooked that in the field of mortgage lending the consumer is also protected by the law on unfair contract terms[232] and the German Civil Code.

2. Issues Regulated

a) Advertisement and Disclosure

Credit institutions are in principle not subject to any special provisions regarding their advertising. They are subject to the law on unfair competition which inter alia forbids misleading information. According to the general provision of § 1 advertising must respect moral standards. Under § 4 of the Price Disclosure Regulation the lender is obliged to include in any advertisement the APRC, if the advertisement contains any interest rate. In the case of a loan with adjustable the so called initial APRC is required.

The transparency of the mortgage offer plays a crucial role in the field of consumer protection. Under § 4 of the Consumer Credit Act the written offer must include the APRC as defined in § 4 II VerbrKrG and calculated by the mathematical formula laid down in § 4 of the Price Disclosure Regulation. Furthermore, the offer must contain the different elements of cost due to the credit (Kreditnebenkosten[233]) and must specify the conditions under which the contract is adjustable. Because of an amendment of the German Consumer Credit Act in 1993 mortgage lenders are no longer held to disclose the total amount of costs (§ 3 II Nr.2 VerbrKG).

229 BT-Drucksache, 11/5462, The reason was: „ daß die meisten Vorschriften des Gesetzes auf grundpfandrechtlich gesicherte Darlehn nicht passen, sofern sie zu für Realkredite üblichen Bedingungen (insbesondere hinsichtlich der Zinshöhe) gewährt werden".

230 Bruchner (1997), Bankrechtshandbuch II, § 81, 50

231 Under § 3 II Nr.2 the provisions: § 4 I 4 Nr.1b, §§ 7, 9, 11, 13 VerbrKrG are excluded.

232 AGB-Gesetz 9.12.1976

233 e.g. :Disagio, Bearbeitungsgebühren, Schätzgebühr, Bereitstellungszinsen, Teilvalutierungszuschläge, Überweisungsgebühren, Bürgschaftsgebühren, Notarkosten, Notarversicherungskosten, Kosten des Grundbuchamtes, Kosten der Be- und Entsicherung, Zwischenfinanzierungskosten, nach Krüger, Peroverde; Rechtsgrundlagen des Realkreditgeschäftes in Das Realkreditgeschäft der Versicherungsunternehmen1997, p.74,75

In general, a lack of information in the credit contract and a violation of § 4 VerbrKrG makes the contract null and void under § 6 I VerbrKrG[234].

b) Cooling-Off Period

The German legislature has decided to exempt mortgage lending from the rules granting a cooling-off period for consumer credit (§§ 3 II Nr.2, 7 I VerbrKrG). The cooling-off period was considered to be incompatible with congruent refinancing[235]. As far as the particular risks of door-to-door selling are concerned special rules based on the Directive 85/577[236] apply, granting a right of cancellation[237].

c) APRC

The German legislation has not adopted the EC-formula to calculate the APRC[238]. When calculating the effective annual rate of interest, all factors determining the price are to be taken into account. The obligation to include the APRC in mortgage offers is contained in § 4 I 4 Nr.1e and II VerbrKrG. The calculation method can be found in the operation-directives of the “Bund-Länder-Ausschuß Preisangaben“ concerning § 4 Price Disclosure Regulation. It is disputed whether the APRC is approriate to make different products comparable, especially as far as so called “Bauspardarlehen“ are concerned[239].

d) Early Repayment

In § 14 VerbrKrG the Consumer Credit Act contains a provision concerning early repayment which, however, is limited to deferred payment in sales contracts. It is not applicable to mortgage lending contracts[240]. The Civil Code provides a differentiated solution in the chapter covering all types of loan contracts in § 609 a BGB[241].

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234 We have to take into consideration the possibility of § 6 II VerbrKrG (Heilung)

235 BT-Drucksache 11/5462, p.18; Bruchner (1997), Bankrechtshandbuch II, § 86, 58; Köndgen (1994), p. 32

236 Council Directive 85/577 of December 20, 1985 to protect consumer in respect of contracts negotiated away from business premises, O.J.1985, L372/31

237 § 1 Haustürwiderrufsgesetz, Law on the revocation of Contracts in Door-to-Door Sales and similar transactions of 16 January 1986, BGBl Part I 122

238 Bockholt (1997), Die Bank, p.250-251; Sievi (1997), FLF, p.45-49 (48)

239 Braun (1997), capital, p.33-34

240 Ott (1994), Verbraucherkreditgesetz, §14, 4

241 Häuser/Welter (1987), NJW, p.17-21 -; Hopt/Mülbert (1990), WM, p.14

In regard to loans outside consumer credit, the law distinguishes between loans with a fixed rate of interest and loans with adjustable rates of interest. In the case of adjustable rates, contracts must grant the borrower the right of early repayment with one month's notice when rates are adjusted (§ 609a I Nr.1 BGB). The lender is excluded from claiming compensation.

In the case of a fixed rate loan the borrower's right to repay can only be excluded for up to ten years. In this case a six month's notice applies (§ 609a I Nr. 3 BGB).

Germany has seen a debate about whether the borrower is entitled to early repayments outside the rules laid down in § 609 a BGB[242]. This mainly concerns so-called hardship cases[243] where the question arises whether the lender may require a compensation for voluntarily resolving the contract[244]. The amount of compensation is only limited by the general rule of good moral (§ 138 BGB)[245]. Among others this was disputed with respect to the principle of good faith laid down in § 242 BGB[246]. The German Federal Court (BGH) recently has held that the borrower is entitled to repay in hardship cases and that the lender may only claim a compensation covering his actual loss.

e) Adjustment

The right to change contract conditions unilaterally is limited by various provisions: § 315 BGB, § 4 I 4 Nr.1 e VerbrKrG, § 4 I and VI PAngV, § 9 AGBG, and by case law. The right of unilateral adjustment must be agreed upon explicitly by the consumer and the lender and it must be laid down under which conditions rates can be adjusted. This, however, does not mean that an indexation is required. It is considered to be sufficient that lenders refer to variable market conditions which will determine their adjustments[247] It is maintained that the unilateral adjustment itself again has to fulfill the disclosure

242 Wehrt (1997), ZBB, p.48-61 (49); Reifner (1995), NJW, p.89; Harbeke (1997), Bankrechtstag, p.89; Metz (1994), ZBB, p.205-214 (206); Köndgen (1994, p.148; Wenzel (1995), WM, p.1435; Canaris (1997), Bankrechtstag, p.7: legal alternatives to introduce a right of early repayment are discussed, in particular, by referring to § 649 BGB, § 157 BGB or the doctrine of clausula rebus sic stantibus.

243 Unemployment, divorce, moving for reasons of employment, Bruchner (1997), Bankrechtshandbuch II, § 78 Rz. 101, LG Hannover, WM 1995, p.192

244 Besides the question whether the lender may require a compensation the quality of the „compensation" is discussed. Price or compensation?, Canaris (1997), p.17-23; Weber (1995), NJW, p.2951-2956 (2952); Wenzel (1995), WM, p.1433-1439 (1436); Metz (1994), ZBB, p.205-214, (209)

245 §138 BGB comes into play if the compensation is qualified as a price . Canaris (1997), Bankrechtstag, p.26; Mues (1996), ZBB, p.252; Wenzel (1995), WM,p. 1438; Weber (1995), NJW,p. 2951, Bruchner (1997), Bankrechtshandbuch II, §78, Rz.102; Reich (1997), Bankrechtstag, p. 59; Harbeke (1997), Bankrechtstag, p.100

246 LG Karlsruhe, WM 1996, p.574, Wenzel (1995), WM, p.1433-1439 (1436);

247 Wagner-Wieduwilt (1994), VerbrKrG, § 4 Rz.115

provision of § 4 VerbrKrG[248]. This is definitely true if the parties switch by agreement from a variable interest-rate-loan to a fixed rate loan[249].

According to § 315 III BGB the borrower can go to court to have the adjustment of interest rate reviewed[250]. Lenders may not reserve the right of adjustment only in their favor. Based on the law against unfair terms (§ 9 AGBG) the courts[251] insist on balanced adjustment clauses[252]. The clause should contain an obligation also to adjust the interest rates in favor of the borrower, if the level of interest rates goes down.

f) Assignment

The German legislature has transposed Art. 9 of the Consumer Credit Directive into § 10 VerbrKrG extending its scope to mortgage lending.

Without the consumer's consent the lender is entitled to assign the debt under §§ 398, 401 BGB. Written form is only required if the debt is secured by a mortgage (§1154 BGB). According to the general rules in the Civil Code the consumer is entitled to plead against the third person any defense which was available to him against the original creditor (§§ 404, 406 BGB) and he is protected when paying the original creditor in good faith (§§ 407, 404 BGB). A provision in the contract which deprives the consumer of these rights is null and void under § 10 VerbrKrG.

As regards § 10 II VerbrKrG which forbids the use of Bills of exchange and cheques it should be noted that this provisions only effect the lender. The rights of a third party are determined by the general rules protecting the good faith (Art. 17 of the Geneva Convention on Bills of Exchange and Promissory Notes).

248 Brandmüller (1993), p.312

249 Köndgen (1994), p. 169, a.A. : Bruchner/Ott/Wagner-Wieduwilt

250 BGH Urteil v. 6.3.1986, BGHZ 97, 212 (223),

251 BGH NJW 1986, 1803/1804; AG Ibbenbüren, decision of April 12, 1996 (3C 910/95)

252 For more details cf: Schmidt-Burgk/Tiffe (1997), Der langfristige Kredit, p.357-362

g) Assumability

Under § 415 I BGB, a debt is in principle assumable with the consent of the lender. In case of mortgage lending contracts § 416 I BGB provides that a consent of the lender is presumed to be given if he has not explicitly refused the consent within six months after having received the debtor's notice[253].

In practice lenders often refuse or raise obstacles by imposing high fees[254]. The German Federal Court, however, has considerably limited their choices. According to case law[255] the lender has to accept the new borrower if the new one is in a financially similar situation[256]. There is some uncertainty about the question if the disclosure provision § 4 VerbrKrG again has to be applied in the case of assuming a debt secured by a mortgage[257].

h) Other Protection Measures

Mortgage contracts like other bank transactions are subject to the law against unfair terms[258]. These rules have become a powerful tool to ensure fair terms in the bank-customer-relationship[259], in particular with regard to the default situation. The German Consumer Credit Act contains a provision in § 11 which entitles the lender to claim 5% over the discount-rate of the Bundesbank in the event of default (D +5 formula). This provision, however, is not applicable to mortgage lending (§ 3 II Nr.2 VerbrKrG) and the Federal court has clearly refused to apply the 5%-clause by analogy to mortgage lending[260]. This is mainly maintained on the ground that the 5%-clause would be too favorable for credit institutions[261]. Mortgage lenders have even found it difficult to conceive clauses incontestably valid in the light of the law of abusive clauses[262].

253 § 416 I BGB:" Übernimmt der Erwerber eines Grundstücks durch Vertrag mit dem Veräußerer eine Schuld des Veräußerers, für die eine Hypothek an dem Grundstück besteht, so kann der Gläubiger die Schuldübernahme nur genehmigen, wenn der Veräußerer sie ihm mitteilt. Sind seit dem Empfange der Mitteilung sechs Monate verstrichen, so gilt die Genehmigung als erteilt, wenn nicht der Gläubiger sie dem Veräußerer gegenüber vorher verweigert hat.

254 Köndgen (1996), p.135

255 BGH v.30.11.1989, WM 1990, 174

256 BGH v.30.11.1989, WM 1990, 174, Köndgen (1994), p.117

257 Hellner/Steuer (1996), Bankrecht und Bankpraxis II, 4/2501

258 § 23 I AGBG, Wolf/Horn/Lindacher (1994), AGB- Gesetz, § 9 G 201

259 Köndgen (1994), p.24

260 BGH, decision of 18/02/92 published in NJW 1992, 1620, commented by Bruchner (1992), WM, p.973

261 BT-Drucksache 11/5462, p.18

262 Köndgen (1994), p.136

Even though German legislation does not explicitly provide for counseling duties, they are presumed by the courts under certain circumstances[263]. This would be the case if the borrower has no experience in lending practice and if the bank proposes a rather unusual financing model[264].

G. Greece

1. Transposition

The Ministerial Decision F1-983 of March 7,1991 transposes Directive 87/102 and Directive 90/88[265]. The Directive is taken over verbatim. It has not been transposed to mortgage lending (Art 7). The mortgage lender is protected by strict banking supervision and general provisions of civil law.

2. Issues Regulated

a) Advertisement and Disclosure

There are no particular advertisement restrictions imposed on credit institutions. They are not required to indicate the APRC in advertising or in the loan contract. There are no provisions about disclosure.

b) Cooling-Off Period

The borrower can cancel the loan application or contract at any time until the mortgage is registered. He is, however, charged with the costs the lender has incurred.[266].

c) Early Repayment

There is no specific legislation regarding early repayment of mortgage loans. In this respect the contract determines the rights and duties of the parties. The National Mortgage Bank of Greece lays down in the

263 Reifner (1991), § 8. Rz.10,11

264 BGH, decision 4.12.1990, ZIP 1991, p.301

265 The decision is published in the Greek Government Gazette, Volume B, 172, 21/03/91

266 European Mortgage Federation (1992), p.56

loan contract the terms and conditions for early repayment. In general the lender is entitled to claim a 6-month interest rate penalty on the prepaid amount plus administrative costs and fees[267].

d) Adjustment

Even though the general provisions of the national Civil Code prohibit the unilateral change of any obligation, it is admitted that contracts reserve this right. This reservation with respect to interest rate adjustments has become common banking practice.

e) Assignment

Under section 455 of the Civil Code the creditor may by contract transfer his claim to another party without the consent of the debtor. This also applies if the debt is secured by a mortgage or other accessory right (section 458). However, the assignee becomes entitled to the claim only when either he or the assignor notifies the debtor[268]. The position of the debtor is not impaired by an assignment. Under section 463 the debtor keeps all the defenses he could invoke against the assignor prior to the notification.

f) Assumability

A third party may, by agreement with the creditor, assume the debt, which has the effect of releasing the debtor. To achieve this legal effect the respective intention of the parties has to be indicated quite clearly. In the absence of such indication of intention the debtor is not released but an additional obligation arises so that the creditor may enforce his claim also against the third party under section 477 of the Civil Code[269].

267 European Mortgage Federation (1992), p-58
268 Kerameus/Kozyris (1992), p 89
269 Stathopouloss (1993)

H. Ireland

1. Transposition

The report on the operation of Directive 87/102 refers to Ireland being about to adopt legislation implementing the directive[270]. In the meantime the Consumer Credit Act (CCA 1995) has been passed and entered into force the 31 July 1995.

The CCA 1995 in principle covers both consumer credit and mortgage lending. In detail, however, different sets of rules apply in each case. Whereas mortgage loans are explicitly excluded in some parts of the CCA (e.g., Part III and V), part IX applies exclusively to mortgage lending.

Practically all of the sections of the CCA 1995 have been implemented. Regarding mortgage lending, section 131 is outstanding as it covers the disclosure of fees, commissions, payments, etc., made by mortgage lenders relevant to the procuration and processing of mortgage loans. In this and other respects the provisions of the 1995 Act go far beyond what the Directive requires for consumer credit.

Section. 2 I defines a Housing Loan as an agreement for credit on the security of a mortgage of a freehold or leasehold estate or interest in a house where

a) the loan is made for the purpose of enabling the borrower to provide or improve the house or to purchase the said estate or interest, or

b) the loan is made for the purpose of refinancing a loan within the meaning of a), or

c) the house is to be used or to continue to be used as the principal residence of the borrower or his dependents.

2. Issues Regulated

a) Advertisements and Disclosure

Part II of the CCA 1995 which applies to mortgage lending deals with the advertising and offering of financial accommodation. Section 21 provides that any advertisement, published or displayed for the purpose of business must contain a clear and prominent statement of the APRC. The Director of Consumer Affairs may give direction to a mortgage agent in relation to the matter and form of any advertisement and may order that incorrect advertisements may be withdrawn.

Section 129 constitutes that an agreement for a housing loan shall on the front page contain a notice of important information regarding:

- the amount of credit advanced
- period of agreement
- number of repayment installments
- amount of each installment
- total amount repayable
- cost of this credit
- APRC
- amount of endowment premium (if applicable)
- amount of mortgage protection premium (if applicable)
- effect on amount of installment of 1% increase in first year in interest rate.

Section 134 provides that mortgage lenders who want to charge interest in respect of arrears on housing loans have to ensure that any information document in relation to arrears of payments states the amount of the increase in interest and other charges.

It should be remembered, however, that section 131 which covers disclosure of fees and commissions has not been implemented yet (see above). This seems to be the major unresolved area in the field of consumer protection in Ireland.

Irish legislation protects the borrower by implementing warning duties in Section 128. All the documents have to include the following notice:

- ”Your home is at risk if you do not keep up payments on a mortgage or any other loan secured on it.”

In the case of an agreement with adjustable rates the lender is obliged to submit the following notice.

- “The payment rates on this housing loan may be adjusted by the lender from time to time.”

b) Cooling-Off Period

In contrast with consumer credit, the consumer does not have the right to withdraw from a mortgage loan contract (Section.50 IV).

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270 Commission of the European Communities (1995), p.68

c) APRC

Section 122 lays down the criteria for calculation of the APRC in relation to housing loans. Irish legislation has transposed the EC-formula introduced in the Directive 90/88. The elements of cost are generally the same as included in Art.1a II of the Directive.

d) Early Repayment

Section 121 (1) constitutes the borrower's right to repay at any time without any redemption fee. This rule, however, does not apply to fixed rate loans which are defined in detail (Section 121 (2)). This specifically includes capped adjustable rates under certain conditions (at least 5 year's term, adjustable by up to 2 percent). As regards the calculation of the admissible redemption fee, special duties for information disclosure are established in Section 121 (5) of the CCA.

Penalties imposed for early repayment may be reviewed by the Director of Consumer Affairs, who has power to adjudicate on unfair terms in mortgage contracts (see infra).

e) Assignment and Bills of Exchange

Irish legislation has directly transposed Art. 9 of the Directive into Section.40 of the CCA 1995 applying to mortgage lending as well. In case of an assignment the consumer shall be entitled to plead against the third person any defense which was available to him against the original creditor.

Transposing Art. 10 of the Directive section 41 I provides that the use of bills of exchange shall not affect the rights and protections available to the consumer. Quite remarkably, section 41 II even preserves these defenses where a bill of exchange has been negotiated by the creditor to a third party. This derogation from the general rules of the Bills of Exchange Act, 1882 only seems to be possible as Ireland is not a Member of the Geneva of Convention and therefore not bound by its Art. 17.

f) Other Protection Measures

The Director of Consumer Affairs controls mortgage intermediaries by requiring all parties wishing to serve in that function to apply for a mortgage intermediaries authorization (Section.116).

Under section 46, which is applicable to mortgage lending contracts, a mortgage lender shall not visit or telephone a borrower without his consent at his place of employment for any purposes connected with an agreement other than the service of a document in connection with legal proceedings.

A mortgage lender shall arrange a life assurance policy providing for repayment of the principal in the event of the death of a borrower before a housing loan has been repaid. This provision in section 126 is applicable with respect to all housing loans with some exemptions where insurance coverage could not be obtained or would be too costly (e.g., loans to persons who over 50 years of age).

Section 127 of the Consumer Credit Act prohibits the linkage of other financial services to the granting of mortgage credit.

On 1 February 1995 the Government introduced regulations applicable to all consumer contracts thereby bringing into effect the Directive on Unfair Terms in Consumer Contracts[271]. The regulations significantly increased the protection afforded to consumers regarding mortgage lending. A contractual term shall be regarded as unfair if, contrary to the requirements of good faith, it causes a significant imbalance in the party's rights and obligations under the contract to the detriment of the consumer, taking into account the nature of the goods or services for which the contract was concluded and all circumstances attending the conclusion of the contract and all other terms in the contract (section 3.2.).

I. Italy

1. Transposition

The Italian legislature has transposed the Directives 87/102 and 90/88 by the Act No. 142 of 19.2.1992[272]. The scope of the Act No 142 is wider than the the scope of the Directives in some respects. However, Art. 2 I a of the Directive, which excludes credit agreements intended for the purpose of acquiring or retaining property rights in land or in buildings or for the purpose of renovating or improving a building has been implemented by Art. 18 IV lit. c) of the Act No 142.

On 1 January 1994, a new banking law has entered into force (so called Testo Unico, enacted by legislative decree 385 on 1 September 1993). The law tries to unify separate legal texts, e.g., transposing individual EEC Directives[273]. Based on the CCD, the Testo Unico contains specific provisions for consumer credits in art.121-126. Mortgage lending contracts, however, are governed by other provisions of the Italian Unified Banking and Credit Act[274] (Art. 40 et seq. and 115 et seq.).

271 Council Directive 93/13 of April 5, 1993 on unfair terms in consumer contracts, O.J. 1993, L95/29

272 Supplemento ordinaro alla Gazetta Ufficiale No.42 vom 20.2.1992, p.12

273 The Italian Unified Banking and Credit Act, translated by Graham & James, Milan, page vii

274 Testo unico delle leggi in materia bancaria e creditizia 1993, published in English in The 1993 Italian Banking law, Testo Unico edited by Franco Riolo

2. Issues Regulated

a) Advertisements and Disclosure

The Interministerial Committee for Credit and Savings[275] shall specify the essential elements that must be indicated in advertising announcements (Art.116 III d Testo Unico).

In July 1989, the mortgage institutions coordinated by the Associazione Bancaria Italiana, voluntarily met an agreement which requires an informative notice to be displayed. It is supposed to list the conditions applied to customers and be displayed in the main office in a place clearly visible to the public. The following elements shall be addressed:

- which types of loans are available and for what duration
- the effective half-yearly rate of a FRM and the initial rate of an ARM
- the maximum costs payable by the customer (any administrative costs and appropriate costs incurred in valuing the property).

On this ground the rules laid down in Art.115 to Art.120 of the Italian Banking law require disclosure of terms and conditions of contract with regard to public notices. They also cover form and content of contracts and unilateral alteration of contracts[276]. Contracts shall be in writing and customers shall be given a copy. Credit agreements shall state the rate of interest and every other price and condition to be applied, including any increase in charges in respect of arrears (Art.117 IV). Apart from such general provisions, however, under Art.116 III the legislature left the specification of disclosure to the Credit Committee.

b) APRC

As regards APRC it should be noted that it takes into account the borrower's liability for notary's fees, taxes and the costs of the valuation.

c) Early Repayment

Under Art. 40 Testo Unico, debtors may prepay all or part of their debt on payment to the bank of a contractually determined consideration related to the amount of the principal prepaid[277].

275 „Comitato Interministeriale per il credito ed il risparmio"
276 Pedretti (1995), p.135-142 (136)
277 see Reich (1997), Bankrechtstag, p.55

In general, Italian mortgage lenders allow borrowers to repay the loan early every three or six months. The maximum amount of the compensation which can be claimed in the case of early repayment has to be disclosed in a price list in all the banking offices.

The situation as regards the compensation, however, is rather complex. The information that it amounts to 1 to 2% may be rather misleading. This applies to ARM where losses for the lender are more or less negligible. If it applies to FRM as well this may be explained by the fact that banks are entitled to call the bonds refinancing the loans.[278] In the case of non-prepayable („non-callable“) bonds placed on the international market, however, the compensation may amount to 1.25% per half year thus reaching 10% if repayment were due after 4 years.

d) Adjustment

Art.117 V of the Italian banking law states that the possibility of adjusting interest rates or any other price or condition in a manner unfavorable to the customer must be required in the contract in a clause specifically approved by the customer. Clauses which refer to usage for the determination of interest rates or any other price or condition to be applied shall be null and deemed not to be part of the contract (Art. 117 VI).

e) Assignment

The mortgage debt is assignable under Art.1263 I Codice Civile, but the transfer of the mortgage is only valid if the assignment has been annotated in the registry book of immovable (Art.2843 I Codice Civile)[279]. The consumer keeps all his defenses against the new creditor[280].

f) Other Protection Measures

The Italian law contains provisions concerning a special mortgage, the “ipoteca cambiaria“ (Art.2831, 2845 Codice Civile). This mortgage is to secure bills of exchange. The Italian banking practice does not seem to make use of this financing instrument in a larger scale because of relatively high taxes on the

278 This is based on standard terms for bonds required by the Banca d’Italia.
279 „annotazione“, Schäfer (1993), p.160
280 Portale/Dolmetta (1986), p.203

combination of bills of exchange and mortgages[281]. That may be the reason for no complaints concerning the transposition of Art.10 of the European Consumer Credit Directive to mortgage lending.

The Codice Civil also comes into play with its rules on abusive clauses (Art. 1469 bis et seq.). They apply to consumer contracts including bank transactions. The provisions aim at clauses unfavorable to customers in various manners and render them null and void. Credit contracts are not addressed specifically in these clauses; on the contrary, they are subject to important exceptions, such as opening the way for unilateral alteration of contracts i.e., ARM.

J. Luxembourg

1. Transposition

The Directive 87/102 was transposed by the law of 9 August 1993 and the Directive 90/88 was transposed by Grand-Ducal Regulation of 26 August 1993.

The law applies to mortgage credits other than those relating to the purchase or renovation of buildings, which means that most of the mortgage lending contracts do not fall under the scope of the Consumer Credit Law. The mortgage loan is not subject to special regulations.

2. Issues Regulated

The law of the Grand Duchy of Luxembourg scarcely deals with issues concerning the protection of the consumer.

a) Advertisement and Disclosure

The Institut Monétaire Luxembourgeois, the supervisory authority for the banking and financial sector, claims to require the submission of all advertising texts. It does not, however, possess the legal means to prevent the publication of any texts objected to.

The loan offer is not regulated. The borrower, at his request, has the possibility of being informed in detail of conditions of the future loan contract. Any information given in this context must be correct according to general rules.

281 Schäfer (1993), p.162; Bodenstein/Jahn (1986) p.141

b) APRC

There are no regulations either on the necessity nor on the calculation of the effective rate of interest.

c) Early Repayment

In the Grand Duchy, all loans are at variable interest rates. Under the terms of the loan contracts, the borrower usually has the possibility to repay the loan in whole or in part at any time. It is not customary in Luxembourg to stipulate compensation in favor of the lender in the event of early repayment.

K. The Netherlands

1. Transposition

The Law on Consumer Credit (WCK 1989[282]) resulted from combining two existing laws on consumption credit and adapting them to the EC Directive on Consumer Credit 87/102. Mortgage credit is subject to specific legislation and does not fall within the scope of the Law on Consumer Credit.

As the Government insisted on a set of rules aiming at protecting the non-professional mortgage debtor a self-regulation-system on mortgage credit came about. It consists of three documents:

- A Contract signed by all professional mortgage lenders in may 1990
- The Code of Conduct of 1 October 1990
- Regulations on the application of the Code of Conduct

The self-regulation system is an agreement between umbrella organizations of mortgage lenders and some individual lenders[283]. It provides for fuller and better information for consumers concerning the loan contract they are entering into.

Other than the self-regulation agreement, mortgage lending is governed by the general law on contract, which leaves great freedom to the parties concerned.

282 WCK: Wet op het Cosumentenkrediet

283 European Mortgage Federation, Annual Report 1991, page 62

2. Issues Regulated

a) Advertisements and Disclosure

In case an advertisement mentions the nominal rate of interest, the advertisement should also contain the APRC. There are semi-government institutions (STER) that supervise advertising of mortgage lenders[284].

Art. 3 of the Code of Conduct provides that the booklets and brochures supplied by the mortgage lender to inform consumers are to contain specified information about the APRC, the costs that a lender will charge on granting a mortgage loan, the dates of payment, the applicable compensatory scheme in case of an extra installment or full early repayment. These booklets and brochures are intended to provide the consumer with a clear and comprehensive overview of the conditions on which a loan is offered and they are supposed to enable the consumer, due to the standardized way in which these issues are mentioned, to make a better comparison between the offers[285].

Under Art. 5 of the Code of Conduct, in a written offer the mortgage lender has to incorporate concrete information, such as the amount of the mortgage loan, the term of the loan, the dates of payment of the periodic installments, the type of interest, the nominal annual rate of interest, the effective annual rate of interest, the applicable compensatory scheme in case of an extra installment or full early repayment, the costs charged by the lender on granting the loan, the period of validity of the offer.

b) Cooling-Off Period

At the moment in the Netherlands there is no cooling-off period, although a three-day period is under consideration.[286]

c) APRC

The mortgage lender is committed to mention the so-called effective rate of interest in addition to the nominal rate of interest. The APRC includes, besides the nominal rate of interest, allowances of the implications of any closing charges, the date of payment and the number of payments that have to be

284 European Mortgage Federation (1992), p.126

285 Explanatory Notes to the Code of Conduct pertaining to mortage credit, Art.3

286 Response to the Questionnaire by „Nederlands Vereniging van Banken“

made annually. The mortgage lender shall apply the calculation formula which is mentioned in the Code of Conduct under Art.6.

d) Early Repayment

Loans are usually redeemed according to a scheme that is laid down in the financing agreement. Art. 8 of the Code of Conduct provides that the mortgage lender shall permit the consumer's early repayment of the mortgage loan.

Even in the case of FRM the borrower is entitled to repay 10% of the initial amount of the loan without any charges[287]. Beyond that, contractual prepayment penalties are common but the limits of the Code of Conduct are respected. The question of compensation in case of full early repayment is specifically regulated in Art.10:

- In the event of a consumer's death the lender shall not charge compensation, if the debt is paid by means of a death benefit.
- When offering to "take along" the rest of the loan at the same interest rate in order to finance a new house: borrowers not taking advantage of this scheme may be charged with a compensation for the early repayment.
- In the event of forced sale the lender should only charge the consumer in case of negligence for which the consumer can be blamed.
- In case the market rate of interest at the time of repayment is higher than the rate of interest which is to be paid by the consumer and in case the contractual terms provide for a compensation based on the discounted value of the difference between the market rate of interest and the contractual rate of interest, the lender should not charge compensation.

e) Assignment

The creditor is allowed to transfer the mortgage to another creditor. Since 1992 an assignment-document must be handed out and a non-formal notice must be given to the consumer[288]. The consumer, however, keeps all his rights. This rule is not explicitly laid down in the Civil Code, but represents the common understanding[289].

287 Art. 9/10 Explanatory Notes to the Code of Conduct pertaining to Mortgage Credit, If the consumer did not make an extra instalment in a particular year, the consumer is nevertheless not permitted to save up the 10 % and repay 20% in the next yearwithout any charges. This signifies the meaning „in a non-cumultative-manner.

288 van Nievelt (1996), p.37; Reich (1997), Bankrechtstag, p.56

289 Stein (1986), p.252

f) Adjustment

In the case of variable interest loans, interest rates may change at a certain date or even on a daily basis. If in such a case, the borrower does not agree with the newly set rate, he has the right to redeem the loan in whole[290].

g) Protection in the Case of Default

If a consumer fails to meet his commitments ensuing from a mortgage loan, the lender shall enter into consultations with the consumer in order to examine whether a reasonable and acceptable solution can be found. The lender shall not sell the mortgaged immovable property under execution before the consultations have taken place (Art.13 of the Code of Conduct).

h) Other Protection Measures

The six important associations of mortgage credit institutions installed a Supervisory Board, which is charged with the execution of the Regulations on the application of the Code of Conduct[291].

Furthermore, consumers are also protected because the content and scope of the general conditions used by individual lenders are limited by the law on unfair terms.

L. Norway

1. Transposition

The EEA Agreement came into force on January 1, 1994. At the same time the Consumer Credit Directive EEC 87/102 was transposed into Norwegian law. The Act on Financing Activity and Financial Institutions from 10.06.1988 no.40 and the Sale of Goods on Credit Act of 21.06.1985 no.82 were amended in the course of the implementation of the Directive.

In general, mortgage lending as a financing activity falls under the scope of the Act on Financing Activity and Financial Institutions (Financial Institutions Act, Chapter 1, section 1-2). The details are regulated either in secondary regulations, supplementing the Financial Institutions Act, or in general

290 European Mortgage Federation (1992), p. 128

291 Regulations of the Supervisory Board concerning the Code of Conduct

agreements concluded between the Ombudsman and the Banking Association. In Norway, according to the Marketing and Contract Terms and Conditions Act the Consumer Ombudsman shall supervise the lenders in the conduct of their operations, by working out standardized contracts. The texts of the secondary regulations and the agreements between the Ombudsman and the Banking Association are only available in Norwegian.

2. Issues regulated

a) Advertisements and Disclosure

Section 2-12 of the Financial Institutions Act rules that the effective interest rate shall be stated in any advertisements, brochures or written material for the marketing of borrowing facilities. Advertising is supervised by the relevant authorities according to the Marketing and Contract Terms and Conditions Act of 16.06.1972 no.47.

The duty to disclose information to borrowers is laid down in section 2-12 of the Financial Institutions Act as well as in secondary regulations concerning the performance of the disclosure duty, which are issued separately by the King. Financial institutions offering mortgage loans shall state in writing the borrowing conditions and the effective interest rate before the loan contract is concluded. Such information shall show the interest rate, the conditions for their adjustment, as well as all other credit costs in detail. In addition, repayment conditions shall be specified in detail.

b) APRC

The calculation formula of the effective interest rate is laid down in a secondary regulation. Principles for calculating the APRC have a relatively long tradition in Norway. All credit costs have to be included in the calculation.

c) Early Repayment

In the past, the mortgage credit institution were not obliged to offer to the borrower the option of early repayment, but recent amendments of the Financial Institutions Act had the effect of rendering early repayment legally compulsory. Section 2-12a of the Financial Institutions Act entitles the King to lay down all further rules. Next to an administration fee (up to approx. NOK 1,000), the lender is entitled to demand a compensation charge if today´s interest rate is lower than the contractually fixed rate.

d) Assignment

The King has laid down rules on debtors' rights in connection with a change of the lender. Debtors have the right to raise the same objections against the new creditor under Section 2-12a of the Financial Institutions Act. However, the borrower has to accept an assignment while keeping all his defences against the new creditor.

e) Adjustment

A mortgage credit institution is not entitled to change the contract conditions unilaterally. However, adjustment of interest rates is possible, if specified in the contract. The borrower has to be informed about an adjustment one month in advance.

f) Overindebtedness

In Norway, overindebtedness is regulated by the Debt Settlement Act of 17.07.1992 no.99. It regulates the conditions for debtors with serious debt problems to obtain debt settlements, either by agreement with the creditors or by confirmation by the Court of Enforcement.

M. Portugal

1. Transposition

With regard to consumer credit, Decree-law no.359/91 of 2 August 1991 incorporates the two Directives No. 87/102 and 90/88 into national law[292]. Some of the provisions apply to certain forms of mortgage credit. There are no specific laws in Portuguese legislation to protect consumers in the field of mortgage lending.

292 The law is published in the Diario Da Republica - I Serie-A, p.4998 ff. of 21/09/91

2. Issues Regulated

a) Advertisement and Disclosure

The Bank of Portugal exercises a supervisory function over advertising. Its Announcement no.1/95 of 17 February 1995 approved the transparency and information rules which financial institutions must comply with. They must make available in their offices, in places which can easily be accessed, up-to-date information on their products written in clear and simple language as well as the general terms which have effects on the operations and services rendered. There are no legal requirements to indicate the effective rate of interest in the advertising brochures or in the loan contracts[293].

b) Early Repayment

The borrower is entitled to repay the mortgage loan early under Art.1147 of the Civil Code and Art. 3.2. of Decree-law no 328-B/86 of 30 September 199?. This concerns both fixed interest rate and variable interest rate loans. The borrower, however, has to compensate the institution according to the penalties specified in the respective contract.

N. Spain

1. Transposition

The Consumer Credit Act[294] has entered into force 23 March 1995 and implements the transposition of the Consumer Credit Directive 87/102 and the Directive 90/88. The Spanish Consumer Credit Act is not applicable to mortgage lending contracts[295].

The Law concerning subrogation and modification of mortgage loans[296] entered into force in April 1994 regulating specific issues which have to be taken into account in this country report.

Lender have to respect a decree (“orden“) about transparency of financial conditions concerning mortgage lending contracts[297]. A mortgage lending contract must fulfill three conditions to fall under the scope of this “orden“:

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293 European Mortgage Federation (1992), p. 142

294 Ley de Crédito al Consumo, Ley 7/1995 23.3.1995, Boletin Oficial del Estado vom 25.3.1995, Nr.72,S.9370

295 Art.1 and 2 of the Ley de Crédito al Consumo, Meyer (1996), RIW, p.299-301

a) the credit must be used to finance a building in Spain

b) the borrower must be a natural person

c) the amount of the credit is not more than 25,000,000.--Pesetas (Art.1 no. 1-3).

2. Issues Regulated

a) Advertisements and Disclosure

Under Art. 3 of the decree, banks have to present an information document (Folleto informativo), which contains the most important information about the mortgage loan, the possible amount of the credit, the period of agreement, APRC, the total amount of costs, and the number of repayment installments. These documents are supervised by the National Bank of Spain[298].

The binding offer must include, under Art. 5 of the decree, all the details specified in its Annex II in the same order: the amount of credit advanced, number and time of the repayment installments and the nominal interest rate, costs (comision de apertura), fees, and interest on arrears.

b) Cooling-Off Period

The bank is bound to its offer for 10 days. An actual cooling-off period does not exist for mortgage loan contracts.

c) Early Repayment

The Spanish legislation introduced the Ley 2/1994 in order to grant the borrowers the right to totally or partly repay the loan early and to profit from decreasing interest rates. Spanish credit institutions used to prevent borrowers from early repayment by imposing high fees and high penalties, which had been agreed in the credit contracts[299]. The law has to be respected by all credit institutions which offer mortgage lending. The compensation is legally reduced to 1% in the case of early repayment under Art.3 of the law. It is not explicitly regulated if the 1%-rule is applicable to both ARM and FRM[300].

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296 Ley 2/1994, de 30 de marzo sobre Subrogación y modificación de préstamos hipotecarios, Boletin Oficial del Estado 4.4.1994

297 Orden de 5.de Mayo de 1994 sobre transparencia, the offer must contain specified details de las condiciones financieras de los prestamos hipotecarios published in the Boletin Oficial del Estado, BOE, (11.5.1994)

298 Norma Tercera Ap.4 des circular 8/1990 , amended by the circular 5/1994

299 Reichmann (1994), RIW, p.1015-1017 (1015)

300 Reich (1997), Bankrechtstag, p.55; FRM do not represent a common financing instrument.

Common understanding of this article is to exempt FRM from the scope[301]. The fixed rate mortgage loan is considered to be a special kind of loan implying regular compensation calculated by the economic loss. At the end of 1996, a limit of 2.5% on the maximum compensation for FRM early repayment was enacted. The lender can charge more if he can show damages in excess of this amount.

d) Assignment

Under Art. 878 of the Civil Code, the bank is allowed to assign a debt of a mortgage contract (participaciones hipotecarios). The mortgagee has to notify the assignment to the borrower, if he has not given his general consent in the contract. Art.151 of the Mortgage Act[302] provides that a missing notification has no impact to the assignment, even without notification the assignment is valid. The debtor keeps all his defenses against the new creditor. Additionally, the debtor is entitled to pay to the assignor if he has not been notified of the assignment.

e) Adjustment

The Bank of Spain is entitled to recommend reference interest rates (indexation) which should be applied to ARM under the Ley 2/1994. The Ministry of Financing and Commerce can prescribe the content of clauses in which the adjustment of interest rates is regulated. In the case of a clause refering to an index outside the official recommendation of the Bank of Spain the customer must be explicitly informed[303].

O. Sweden

1. Transposition

In Sweden, mortgage loans have been covered by the Consumer Credit Act since 1979. The Directives 87/102 and 90/88 were transposed into the Consumer Credit Act No. 1992/830 of 1993, and most recently amended l1 January 1996. This act covers in principle all types of consumer credit, including

301 Reichmann, (1994), RIW, p.1016

302 Ley Hipotecaria entered into force 8 february 1946

303 Reichmann (1994), RIW, p.1015-1017(1017)

mortgage lending contracts. The CCA entrusts the Consumer Board with a strong position. The board has issued guidelines for the commercial practice under the Act[304].

2. Issues Regulated

a) Advertisement and Disclosure

Under section 6 of the Act, the lender is obliged to provide information concerning the effective rate of interest for the credit in all advertising.

The CCA states that the APRC must be provided to the consumer in writing before the agreement is entered into force (section 7). Compulsory information in the agreement refers to interest rate, costs in connection with the credit, and the conditions for adjustment in both costs and interest rate. Section 5 of the Act states that the lender in his relations with the consumer shall observe good business practice when granting credit and in so doing adequately safeguard the interests of the consumer. According to good business practice[305] the following information is regarded as information that shall be included in the agreement: the adjustment mechanism, the total amortization time, the amortization amount per year, and when and how often per year the amount is to be paid.

b) Cooling-Off Period

In Sweden, the law on mortgage lending does not include a cooling-off period.

c) APRC

According to the Guidelines for the Application of the CCA (appendix 4) lenders have to publish the APRC and the law demands compulsory costs to be included.[306] The method that is to be used is described in appendix 4, page 18 of the law.

304 Strömholm, (1991), p.293, Swedish National Board for Consumer Policies Code of Statutes (KVFS 1992:4), published 30 December 1992

305 Good business practise means common market practise and guidelines issued by the national Board for Consumer Policies and the Financial Supervisory Authority

306 Olsson (1997), p.2

d) Early Repayment

The borrower is entitled to repay the mortgage loan early under section 20 of the Act if he is a consumer according to the CCA.

In the case of a mortgage loan with fixed interest rates, the mortgage credit institution is entitled to a interest rate compensation, if the compensation is contractually determined[307]. Such an interest rate compensation may, at the most, be the difference between, on one hand, the interest on the loan and, on the other hand, the interest rate on Government bonds with the same maturity as the remaining loan period plus one percent[308]. If the remaining period of the loan is less than one year, the interest rate on Government bonds should be replaced by the interest rate on treasury bills with the same maturity as the remaining loan period. It should be noted that mortgage institutions are obliged by Swedish law to minimize the costs by reinvesting the prepaid sum as favorably as possible[309].

Penalties are not allowed in the case of a variable rate loan.

e) Adjustment

Section 11 of the CCA requires a statement of conditions regarding the adjustmentof interest rates in the contract.

Even if this is respected the law only allows adjustments under certain conditions. An indexation is generally admissible. The law defines indexation as the interest rate being related to changes in a base interest on which the creditor has no significant influence. Under certain circumstances adjustments, to a greater or lesser extent than result from the linkage with a base interest, are admissible.

Adjustments to the disadvantage of the consumer are admissible to the extent justified by official credit policy decisions, increased loans costs for the creditor, or other increases in costs which the creditor could not reasonably foresee.

In the case of a fixed rate loan for housing purposes with a total duration of at least 30 years the lender may adjust the interest rate on the expiry of the part of the agreement for which the interest rate is fixed (not less than 3 months). The adjustment must be provided in the contract and the adjusted rate must

307 Regulation 1994:30, Financial Supervisory Authority, on the early repayment of mortgage loans
308 Section 24 II of the Consumer Credit Act
309 Commission of the European Communities (1995), p. 55

equate with the interest generally employed by the creditor for new credit of a corresponding nature, if this is provided in the contract.

f) Assignment

If the creditor has transferred his rights under the credit agreement, the consumer may make the same objections against the new creditor which he could have made against the transferor at the time of the transfer under section 16 I of the CCA.

g) Other Protection Measures

In Sweden the use of bills of exchange is prohibited in consumer credit sales, but the legal validity of letters of exchange is not affected (section 17 of the Consumer Credit Act).

The Swedish legislature has introduced in 1994 an Act on Overindebtedness, This Act was a consequence of the housing crisis in 1991-1994. The debtor benefits from a two-step procedure, by which a program will be worked out to overcome the overindebtedness. According to the Act debts can be rescheduled for up to 5 years and the interest on arrears may be limited[310].

P. United Kingdom

1. Transposition

In the UK, the Consumer Credit Act 1974 regulates all aspects as to how credit up to £15.000[311] is either provided or promoted to potential borrowers. In several respects the Act is much wider in scope than the CCD 87/102. British law only had to introduce minor amendments to transpose the Directive, for example the Consumer Credit Regulation Statutory Instrument 1984/1600 of 22 October 1994 concerning the APRC[312]. In principle, recent legislation tries to deregulate the field of consumer protection in order to reduce the burden of regulation on business without detriment to the interests of consumers[313].

310 see for more details: Bogdan (1995), ZEuP, p. 617 ff.

311 Council of Mortgage Lenders, Circular: Consumer Credit Act 1974: Deregulation, 18.2.1997: It is intended that changes should be introduced and the limit increased from.£15,000 to £ 25,000.

312 Diamond (1994), p.352

313 Parliamentary Statement on Consumer credit, Deregulation: November 1996

Basically, mortgage lending is included, e.g., where the loan is secured by a legal charge over residential property (Part VIII ss.105-126)[314]. However, mortgage lending which exceeds £15.000 is exempt from the requirements of the CCA. In addition to that, Section 16, exempts most agreements secured by land from the provisions of the Act if the creditor falls within a defined class of lender (notably local authorities and building societies)[315]. It is evident that most mortgage lending is not subject to the CCA, either on account of the amount involved or with respect to the defined class of lender.

A loan which falls within the scope of the CCA is a so-called “regulated agreement“ in contrast to an “unregulated agreement“. This difference should be kept in mind to fully understand the following text concerning the issues regulated.

If a loan is not governed by the CCA 1974 (unregulated loan), the voluntary Code of Mortgage Lending Practice with effect from 1 July 1997 is applicable[316]. The Mortgage Code was produced by the Council of Mortgage lenders which represent mortgage lenders in the UK producing 98% of the mortgage business conducted, following consultation with mortgage lenders and consumer bodies. It will provide a framework within which mortgage lending will take place in the future. It covers the process from initial marketing, helping the customer to choose a particular loan, through the procession process.

2. Issues Regulated

a) Advertisements and Disclosure

British law contains detailed provisions concerning the content of advertising[317]. All advertisements for mortgage credit are regulated by the CCA 1974 for any amount secured on land. Even if a mortgage exceeds £ 15,000, advertising is regulated by the Act[318]. Section 44 of the CCA authorizes the Secretary of State to make regulations as to the form and content of credit advertisements.

The Code of Mortgage Lending Practice, which is effective from 1 July 1997 will ensure that all advertising and promotional material is clear, fair, reasonable, and not misleading.

If the CCA is applicable, section 61 requires regulated agreements to be in writing, to contain all the express terms of the agreement, and to be readily legible. Section 107 of the CCA 1974 provides that

314 Ellinger & Lomnicka (1994), p.660

315 Goodge (1974), Chapter 15, 1

316 The Code of Mortgage Lending Practice, Council of Mortgage Lenders

317 Commission of the European Communities (1995), p.74

318 Response by Barclays Mortgages to the questionnaire of the study team, 13.5.97, p.2

the creditor has to disclose the amounts payable under the regulated agreement and that mortgages must contain specified information, details of which are set out in the Consumer Credit Regulations 1983. The Agreements Regulations require that all the financial information is set out in one place, that the APRC must be included no less prominently than other information, and the total cost of credit must be included[319].

The Code of Mortgage Lending Practice states under paragraph 3.2, which information must be given to the borrower[320] in the case of a non-regulated credit contract:, e.g., an explanation of the effect of failing, an explanation that early repayment of a mortgage can have adverse financial consequences, a description of the types of interest rates available, a general description of any costs, fees or other charges in connection with the mortgage, an explanation of whether the mortgage can be continued if the consumer moves house (portability).

b) Cooling-Off Period

Customers of *regulated agreements* under the CCA (see above), have the right to withdraw from the contract, thereby bringing into effect the following procedure[321]. Section 58 of the CCA provides a withdrawal procedure for contracts secured by mortgages on land. First, the lender must send the borrower a copy of the prospective agreement which contains a notice in the prescribed form. For 7 days, the lender must not contact the borrower in connection with the loan, except at the borrower's request. At the end of the week, if the borrower has not given notice that he or she wishes to withdraw, the lender may send the full agreement for signature. Finally, after the signed agreement has been returned, the lender must within 7 days, send the borrower a copy of the executed agreement to keep for information. This has the effect of giving the mortgagor a cooling-off period[322].

No cooling-off period is granted for *unregulated agreements.*

c) APRC

Regulations made by the Secretary of State under section 20 of the Consumer Credit Act 1974 specify what should be included in the total charge for credit and how the APRC should be calculated. The cost elements included or excluded in the APRC calculations under the Act are broadly similar to those

319 Molnes Holden (1993), 4.39
320 Council of Mortgage Lenders; The Code of Mortgage Lending Practice, paragraph 3.2
321 Response by Barclays Mortgages to the Questionnaire, 13.5.1997, p.9
322 Ellinger & Lomnicka (1994). p. 660

detailed in the 90/88 Directive. The APRCs are required to be included in all regulated credit agreements issued by lenders under the Act.

d) Early Repayment

The right of redemption is a principle developed in regard to mortgages over land. A borrower has the common law right to repay a mortgage early, whether in full or in part to redeem or free his property from the mortgage[323].

The right of redemption cannot be excluded by agreement. However, institutions in the UK may discourage early repayment by imposing charges, especially in the case of fixed rate mortgages, on loans which are redeemed early. There are no special legal restrictions on the right of the lender to levy repayment penalties. However, any charge will be subject to an assessment of reasonableness in the context of Unfair Terms and Consumer Contracts Regulations and may be challenged in court or by a complaint to one of the relevant Ombudsmen in the UK if it is thought to be unfair[324]. Mortgage terms and conditions typically require that if the mortgage is to be repaid early in full, every other mortgage on the property should also be redeemed, even if other loans are with other lenders. Early repayments are frequent in the event of borrowers having to move.

e) Adjustment

The scope for lenders to unilaterally change their contract conditions is limited by regulations implementing the Directive on Unfair Terms in Consumer Contracts[325]. Adjustments are made at each lender’s discretion, but in accordance with the terms detailed in the credit agreement with the customer. In practice, lenders try to ensure that their adjustable rates are not out of line with other mortgage lenders, as a result of the extremely competetive mortgage market[326].

f) Assignment

A lender usually has the power to transfer the mortgage loan to another mortgage credit institution. The mortgage offer will state that the lender has the discretion to ”transfer, assign or charge” the mortgage

323 Ellinger &.Lomnicka (1994), p.637
324 Response by the Council of Mortgage Lenders to the Questionnaire, 20.3.1997, p.4
325 Council Directive 93/12 of April 5, 1993 on Unfair Terms in Consumer Contracts, O.J.1993, L95/29
326 Response by Barclays Mortgages to the Questionnaire, 13.5.1997, p.10

loan, without the consent of the borrower, to any other institution which will then be able to exercise all of the rights of the original mortgagee.

In case of residential mortgages, in 1989, most lenders adopted a Statement of Practice on the Transfer of Mortgages[327]. In the late 1980s the development of a secondary mortgage market led to concerns being expressed about the rights of existing and new borrowers if their mortgages were to be transferred to another holding organization. The Statement of practice addresses that situation. It requires the lender to obtain the borrower's consent in order to transfer a mortgage outside its company group. This will usually be by way of general consent by the inclusion of a term in the mortgage offer.

In general, one may find agreements under which the original lender continues to conduct arrears cases as the agent of the transferee (otherwise, the transferee would be entitled to arrears of interest[328]), and the agreement specifies that the transferee's policy on handling arrears will be identical to that of the original lender and it must be specified that the transferee's policy in exercising any discretion in the setting of mortgage interest rates will be identical to that of the original lender[329].

g) Other Protection Measures

Everyone who carries on a consumer credit business or a brokerage business in the UK needs a license from the Office of Fair Trading. A license may be refused by the Director General of Fair Trading, on the grounds that the applicant is engaged in business practices which appear to be deceitful or oppressive, or otherwise unfair and improper, whether or not the practice is unlawful.

Section 126 CCA contains a very important provision for regulated agreements. If a regulated agreement is secured by a land mortgage it is enforceable on an order of the court only.

Up to 1995 there was a scheme in the UK whereby state benefit was paid to mortgage borrowers who were unable to pay the interest on their mortgages through unemployment. Subsidies were paid on interest alone. All payments of income support would be paid directly to the lenders.

In the UK credit information is provided by firms acting on a purely commercial basis. Such firms are not subject to any specific control.

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327 The statement of practice was prepared by a working group established by the Department of the Environment and the Treasury. The group included representatives of mortgage lenders, consumer organisations, regulatory bodies and government departments. The statement was introduced on 30 November 1989 which Michael Howard, Minister of Housing and Planning invited all mortgage lenders to adopt it.

328 Cousins (1992), p 385,386

329 Response by Barclays Mortgages; study on mortgage credit in the EEA; 19.5.1997

The express terms of the agreement will be subject to statutory controls intended to protect consumers against unfair terms in the Unfair Contract Terms Act 1977 and the Unfair Terms in Consumer Contract Regulations 1994, implementing EC Directive 93/13[330].

330 Council Directive 93/13 of April 5, 1993 on Unfair terms in Consumer Contracts, O.J.1993, L95/29

ANNEX

A. REFERENCES

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B. NATIONAL REPORTS ON MORTGAGE MARKETS[331]

AUSTRIA

I. General Description of the Market for Mortgage Credit

The Austrian universal banking system is characterised by seven sectors which grant mortgage loans. These are joint stock banks and financiers, savings banks, Landes-Hypothekenbanken, the farmers' co-operative bank sector, the co-operative bank sector, the Bausparkassen and the specialised banks. It is unfortunately not possible to indicate mortgage loans for the residential sector separately on the basis of the present National Bank statistics. The term "mortgage loans" therefore refers to all loans secured by mortgage, irrespective of the purpose for which they are to be used.

Market shares by type of institution
Mortgage and communal loans outstanding (% of total - End of 11/95)

Joint stock banks and financiers	15.2%
Savings banks	25.6%
Landes-Hypothekenbanken	19.0%
Farmers' cooperative bank sector	10.2%
Cooperative bank sector	2.8%
Bausparkassen	19.8%
Specialised banks	7.4%

Joint stock banks and financiers
Lending: Fixed-interest and variable-interest loans with terms of up to 20 years, with the period of fixed interest not exceeding 10 years.
Funding: As a universal bank sector, these banks fund through savings deposits, surrogate savings deposits, borrowing, own bonds and other securities. The Creditanstalt, as a mixed mortgage bank, is also entitled to issue mortgage bonds.

Savings banks
Lending: Fixed-interest loans (period of fixed interest up to 10 years) and variable-interest loans.
Funding: This group of universal banks also funds through savings deposits, surrogate savings deposits, borrowing, own bonds and other securities, with savings deposits and their surrogates being of particular significance. Bank Austria and GiroCredit are entitled to issue mortgage bonds.

Landes-Hypothekenbanken
Lending: The loans have a term of up to 20 years, generally with a period of fixed interest of 5 to 10 years being agreed. First mortgages with a lending limit of 60% of the conservatively estimated value of the real estate are eligible as cover for mortgage bonds.
Funding: Alongside funding through mortgage and communal bonds, the Landes-Hypothekenbanken obtain resources by issuing loans, own bonds and other securities. Through their continued development into universal banks, savings deposits have also become increasingly important in recent years.

331 Source for this section: European Mortgage Federation, to be published soon in Hypostat. Finland not available.

Farmers' cooperative bank sector and Cooperative bank sector

Lending: Like the other sectors.

Funding: Normal sources of funds of universal banking business with an emphasis on primary resources.

Bausparkassen

Lending: After a saving period generally of six years, the saver under the Bausparkassen scheme is entitled to a loan at 6% for a term of 20 years. In addition, the Bausparkassen offer rapid saving rates with an allocation period of 18 to 24 months. Bausparkassen also provide bridging loans.

Funding: A closed system exists at the Bausparkassen, which means that each customer concludes a saving-for-home-ownership contract at a fixed rate of interest of 4.5%.

Specialised banks

Lending: Long-term mortgage loans in the industrial and municipal sectors.

Funding: Capital market

II. Market developments during the past 10 years

During the past decade, the market was characterised by a very strong demand for mortgage loans. The explanation for this strong growth lay primarily in the demographic trend, which showed a strong influx of foreigners into Austria. The construction industry reacted to this influx and to the increased trend in favour of single dwellings with a very sharp increase in output. This trend reached its peak in 1996. In future, a declining trend in new building output is to be expected.

The substantial demand for "moderate-cost" housing caused the legislator to create a new type of specialised bank, the so-called housing construction banks. These banks issue "housing construction loans" (convertible bonds), the interest rate on which is exempted to up to 4% from capital yield tax. The funds thus contributed must be invested in subsidised housing construction. In the meantime, all Austrian credit institution sectors have a specialised bank of this kind at their disposal.

Finally, it should be pointed out that, as already mentioned above, the focus on the housing market is shifting increasingly from new building to the redevelopment and renovation of housing.

BELGIUM

I. General Description of the Market for Mortgage Credit

Credit institutions, essentially represented by the seven major banks (BACOB, BBL, CCB, CERA, CGER, Generale Bank and KB), are the main suppliers of mortgage credit. These seven banks account for 70% of the volume of mortgage credit granted in 1994-1997 and have a significantly greater market share than other credit institutions, financial institutions (OCCH, housing funds), insurance companies, mortgage credit companies, regionalised public housing companies and certain social security companies.

Market shares by type of institution
Residential and commercial mortgage loans outstanding (% of total - End of 1996)

Credit institutions	72.3%
Insurance companies	11.6%
Other sectors (social housing, mortgage credit companies etc.)	16.1%

Lending:
At the end of 1996, the total volume of outstanding mortgage loans contracted principally by private individuals in Belgium to finance real estate for residential or professional purposes amounted to approximately BEF 2 200 bln.

The total volume of the 170 000 mortgage loans granted in 1996 to private individuals to finance real estate for residential purposes amounted to BEF 402 bln. The members of UPC-ABCI account for 90% of the total Belgian mortgage market. The average value of each loan amounted to BEF 2.4 mio.

In 1996, 38% of loans granted were intended to finance the purchase of a building, 20% for construction, 10% for conversion and 8% for purchase + conversion. Of the remaining 24%, 18% were intended to replace existing loans by loans at a lower rate and 6% were granted for other purposes.

Funding:
The main sources of finance for mortgage credit institutions in Belgium are as follows: current accounts of both private individuals and companies, time deposits, savings deposits, cash vouchers and bonds. At the end of 1996, regular savings deposits amounted to BEF 3,257 bln (ECU 81,9 bln), time deposits amounted to BEF 1,678 bln (ECU 42,2 bln), cash vouchers and bonds to BEF 3,545 bln (ECU 89,2 bln) and current accounts to BEF 1,508 bln (ECU 37,9 bln).

II. Market developments during the past 10 years

- A very large number of large, medium and small-scale lenders (+/- 280 legal entities) still operate on the market. These lenders represent a highly diversified range of types of undertakings (banks, savings banks, insurance undertakings, mortgage credit companies, housing funds, regionalised public social housing institutions and their approved credit institutions, discount banks, public services, etc.);
- Substantial rise in market share of the major banks and very strong competition between them as regards both new production and the replacement of existing loans by cheaper loans;
- The cross-frontier credit business of Belgian institutions has remained very limited so far. In recent months, two German institutions and one Dutch institution have made their appearance on the Belgian market by setting up branches;
- Since the end of the 1980s, endowment mortgages have lost a significant market share, accounting now for only about 1% of new loans;

- The legislation on mortgage credit, which dated back to 1936, was amended substantially for the first time in 1992 (entry into force in practice from the end of 1994). It continues to be the subject of constant attention on the part of the public authorities who wish to tighten up the regulations further, with a view to assuring greater consumer protection, and to make the legislation on consumer credit and mortgage credit more homogenous. The new legislation has greatly extended the possibilities for granting various types of loans. In 1992, a (very limited) system of variable mortgage rate loans was introduced.

Since mid-1995, a new law has provided for the possibility of taking out a mortgage to secure future debts;

- The first housing loan securitisation operations took place in 1997. Belgian lenders do not issue mortgage bonds (Pfandbriefe) and no legal framework exists in this context;
- The treatment of mortgage credit for tax purposes has become very complicated over time, with limited tax deductibility of capital repayments and payments of insurance premiums from income tax on the one hand, and a reduction in taxable income for interest payments, on the other;
- Mortgage rates have fallen sharply in recent years. This situation has prompted borrowers - especially since 1996 - to apply for the replacement of their existing mortgage loan by a cheaper loan or for unilateral concessions from their lender regarding the interest rate on their loan. It is presently impossible to measure the consequences of this situation on the loan portfolio of the mortgage institutions;
- Funding instruments for mortgage loans: in the absence of comparable objective bases, credit institutions have long used the rates of government securities. Since the interest rate swaps market (IRS) has become sufficiently developed, use has been made of the latter, which are real market rates traded throughout the world. The fact of switching to IRS has caused rates to rise by about 0.20% per year.

DENMARK

I. General Description of the Market for Mortgage Credit

The Danish mortgage credit market is dominated by the specialised mortgage banks whose gross mortgage lending amounted to around 214.5 bln in 1996, which is about 90 per cent of the total amount in 1995. In recent years the market share of mortgage banks has not been below 80 per cent.

Market shares by type of institution
Residential and commercial gross mortgage loans (% of total - End of 1995)

Mortgage banks	91.1%
Banks	4.4%
Insurance companies	0.5%
Private mortgage financing	4.0%

Mortgage banks

Lending: Danish mortgage banks grant loans both for residential, agricultural and other commercial purposes. The maximum maturity for a mortgage loan on residential buildings is 30 years. For commercial buildings the maximum maturity is also 30 years. The rate of interest is determined by prevailing market conditions at the time of issue of the backing mortgage bond. New properties can also be financed by index-linked loans. This type of finance is , however only predominant in the rented sector. Mortgage banks can lend up to 80 per cent of the value of residential property and up to 60 per cent of the value of industrial premises.

Funding: takes place through the current issue of mortgage bonds. The mortgage banks have a monopoly over the issuing of mortgage bonds. The rate of interest is fixed on the Copenhagen Stock Exchange on a daily basis. At the end of 1996, the total volume of mortgage bonds in circulation amounted to DKK 945 bln. This represents an increase of 5 per cent in relation to 1995.

Banks and insurance companies

Lending: Variable interest rate loans as a general rule.
Funding: All means, although in principal through deposits and insurance premiums.

II. Market developments during the past 10 years

The rapid developments taking place during the past years within the Danish financial sector have caused increasing competition and extensive structural changes. Consequently, commercial banks have recently established mortgage banks. Divisions within the financial system have become less clear-cut, and the consumer has thus benefited from a wider range of financial products.

FRANCE

I. General Description of the Market for Mortgage Credit

Market shares by type of institution

As far as outstanding mortgage loans are concerned, the French mortgage market is essentially divided between the banks (36%), the mutual and cooperative sectors (mainly Crédit Agricole and Crédit Mutuel - 32%), Crédit Foncier (13%), the savings banks (10%) and specialised institutions (8%) (data end of 1996).

Lending

Traditionally, a distinction is drawn between three sectors in France:

1. Loans to the non-subsidised sector
2. Loans to the subsidised sector which comprises three major products:
   - Loans intended to build social housing for rent managed by public housing bodies or private investors *(Prêts locatifs aidés - PLA)*.[332]
   - Zero-rated loans to obtain home ownership which replace the system of loans for accession to ownership (*Prêts d'Accession à la Propriété - PAP*), rescinded by a decree of 31 October 1995.
   - Saving-for-home-ownership loans, which entail, during the saving period, a State premium in addition to the controlled rate of interest paid by the banker and, during the repayment period, a reduced-rate loan.
3. Loans granted under government contract for rented or owner-occupied accommodation, the so-called regulated sector, do not receive direct government aid. They are distributed by banks and institutions which have signed an agreement with the government.

In France, the majority of the loans distributed to households and to legal persons, apart from public housing bodies, are loans at fixed rates which are repaid in constant instalments comprising both capital and interest. The loans secured by mortgage account for about three-quarters of output.

Funding

The securitisation of mortgage loans, is a recent instrument. A common claims fund was first created on the initiative of the Crédit Foncier de France in 1991 for an amount of FRF 1 bln. Since 1994, activity has gathered pace. In 1995, with four funds set up with a total of FRF 4.97 bln, production was lower than in 1994. In total, since the start, 10 common claims funds have been created with total issues of FRF 14.44 bln. The volume of mortgage bonds issued rose from FRF 5.4 bln in 1994 to FRF 8 bln in 1995.

332 The housing financed is available to households whose income does not exceed a certain threshold adapted according to the structure of the household and the geographical area. There are two financial channels, each with their own specific characteristics as regards rate or lending limit: the Caisse des dépôts et consignations for the bodies responsible for public housing and SEM and the Crédit Foncier de France for all construction firms.

II. Market developments during the past 10 years

Two major trends have occurred on the mortgage market:
- the mortgage security has been replaced to an increasing extent by a personal surety, the guarantee given by specific financial institutions for loans to private individuals. Whereas 10 years ago only the mortgage security existed in practice, today it only covers about 3/4 of loans to private individuals;
- the subsidised loans to boost home ownership distributed by the Crédit Foncier de France and the real estate credit companies 10 years ago, have been granted by all credit institutions (zero-rate loan) since the end of 1995. The result is an increase in market shares for the credit institutions, to the detriment of the specialised institutions and the Crédit Foncier. In addition, the mutualist sector is that which has increased its market share the most, since its presence is greater in the personal loans sector. In total, housing credit for private individuals is being made commonplace, the outstandings from which have grown little since 1990. This boosts competition between lenders.

GERMANY

I. General Description of the Market for Mortgage Credit

There are four main groups of lenders granting mortgage loans to finance housing: private and public Pfandbrief-institutes (private mortgage banks and public sector banks), private and public Bausparkassen, the universal credit institutions (savings banks, Landesbanken, commercial banks and cooperative banks) and the insurance companies. Often the universal banks are at the same time parent companies to specialised mortgage bank subsidiaries or Bausparkassen.

An important characteristic of the German mortgage market is that institutions of each group of institutions, with institutions of other groups, offer housing finance packages from a single source (e.g. combination of a mortgage loan with a loan under the saving-for-home-ownership scheme or a fixed-interest loan with a lower ranking variable-interest loan).

Market shares by type of institution

Residential mortgage loans outstanding (% of total - End of 1996)

Savings banks	24.7%
Mortgage banks	19 %
Central banks/credit cooperatives	13 %
Public sector banks (Girozentralen included)	11.1%
Bausparkassen	10.7%
Insurance companies	7.1%
Other credit institutions	14.4%

MORTGAGE BANKS

Lending:

The loans are normally granted for 25 to 30 years, generally with an agreed initial period of fixed interest of 5 to 15 years. First-ranking mortgages, whereby the loan may not exceed 60% of the value assessed in accordance with strict rules, may be used to cover mortgage bonds. Moreover, mortgage loans not used for cover may be granted to a limited extent.

Funding:

The private mortgage banks are refinanced mainly by the issue of mortgage bonds and to a limited extent, i.e. for loans which exceed the prescribed 60% lending limit for refinancing by means of mortgage bonds, by other bank bonds. Mortgage bonds are always fully covered by mortgage loans which match the bonds in terms of volumes and maturities. On account of this matching imposed by law, the interest is fixed for a period laid down by contract and early repayment of the loan before 10 years can be precluded. The mortgage banks are pure capital market institutions. They have virtually no branches, but as a rule have the possibility of selling their products through the branch networks of the major banks and other intermediaries.

BAUSPARKASSEN

Lending:

After a certain period of saving, which amounts to 6 to 7 years on average, the saver has a right to a loan. These loans are available at a low interest rate and in general run for between 7 and 16 years. The Bausparkassen also grant, to a limited extent, temporary advances or bridging loans to their savers.

Funding:
Irrespective of whether or not he plans to take out a loan at a later stage, each saver must conclude a contract with the Bausparkasse. This is a "closed" system and the Bausparkasse pays a fixed rate of interest on the instalments which is independent of the market rate and amounts to the rate chosen by the customer.

SAVINGS BANKS

Lending: Variable rate loans and loans at fixed rate up to 5 years.
Funding: Primarily from deposits by private customers and savings certificates. They have an extensive branch network.

PUBLIC SECTOR BANKS (GIROZENTRALEN INCLUDED)

Lending: Commercial and housing credit form the essential components of the assets-side business. In the mortgage sector, the Landesbanken and Central Giro Institutions grant long-term loans for a period of between 25 to 30 years. Interest rate adaptations are in general agreed after a period of 5 to 10 years.
Funding: The public Landesbanken/Central Giro Institutions refinance their credit business essentially by issuing bonds and through liabilities to customers, particularly institutional investors, as well as to credit institutions. As in the case of the mortgage banks, first-ranking mortgages are financed by mortgage bonds.

CREDIT COOPERATIVES AND COMMERCIAL BANKS

Lending: Variable rate and fixed rate loans.
Funding: Normal sources of funds from banking business.

LIFE ASSURANCE COMPANIES

Lending: Mortgage loans linked to life assurance.
Funding: Insurance premiums.

II. Market developments during the past 10 years

Over the past 10 years, the trend in building activity in Germany has been subject to substantial fluctuations (indicator: building permits for housing). The rise and fall in the permit figures followed the trend in "disposable income", i.e. the trend in households' net income, with a time lag of about 2 years.

An additional demographic factor was the increased influx of emigrant settlers in Germany, especially during the second half of the 1980s.

German reunification produced a very strong rise in the building permit figures. On account of the very high demand for accommodation there, dynamic trends in both new building and total redevelopment were to be seen in the early 1990s.

The financing business of the national credit institutions (indicator net lending) also followed the trend in building activity, with the share in commercial financing (offices and commercial premises, hotels, etc.) also depending on the trend in net income. This explains the enormous boom from 1991, which lasted until mid-90.

Admittedly, building activity has fallen off since this time. The decidedly low level of interest rates has nevertheless continued to date to ensure a high demand for credit.

GREECE

I. General Description of the Market for Mortgage Credit

Mortgage credit is no longer an exclusive government-controlled activity in Greece. All banks, private or state-owned, may now extend loans for housing purposes. Nevertheless, the two major banking institutions extending such credit, namely the National Mortgage Bank and National Housing Bank, are under State control. The National Mortgage Bank presently holds a 43.1%market share in housing loans during the year 1996 against 46.4% in 1995

Market shares by type of institution

Residential mortgage loans outstanding (% of total - End of 1996)	
National Mortgage Bank of Greece	43.1%
Other institutions (including National Housing Bank of Greece etc.)	56.9%

National Mortgage Bank of Greece

Lending: Interest rates on various types of housing loans can be altered to reflect market conditions. The amount of a loan depends on the purpose for which it is obtained and the market value of the building it is intended for. The maturity of loans varies from 3 to 20 years. Loans extended for purposes other than housing are those to the tourist industry (hotels), educational institutions, hospitals, newspaper establishments, etc.

Funding: Deposits (housing savings, blocked and sight deposits) and mortgage bonds. The bank is limited as to the outstanding balance of bonds in circulation. The issue of bonds and interbank borrowing are subject to approval by the Committee of Financial Markets.

II. Market developments during the past 10 years

The gross amount of mortgage lending has increased significantly due to the fall in interest rates.

IRELAND

I. General Description of the Market for Mortgage Credit

The building societies and associated banks continue to dominate the Irish mortgage credit market. The banks maintained their competitive drive for market share in 1996 and captured 65% of gross residential mortgage lending. Fixed rate loans accounted for 56% of residential mortgage lending in 1996, leaving 44% for variable rate loans, while the market share of annuity mortgages was 95% compared to only 5% for endowment.

Market shares by type of institution
Residential mortgage loans outstanding (% of total - End of 1996)

Building societies	33.7%
Associated banks	66.3%
Local Authorities	1.5%
Other	7.6%

Building Societies
Lending: Loans by way of mortgage secured by a first charge on real property.
Funding: Saving deposits through branch network plus funding on wholesale inter bank markets.

II. Market developments during the past 10 years

The residential mortgage market in Ireland has grown strongly in recent years as a result of a buoyant Irish economy, increased consumer confidence, favourable demographic factors, and falling interest rates.

The attractiveness of the mortgage market and an apparent reassessment of the profitability of mortgages resulted in a competitive and successful drive for new business by the associated banks.

The increased competitiveness in the market led to a squeeze on net margins as financial institutions attempted to gain new mortgage business by offering discounted mortgages and to gain new deposit business by offering more attractive rates on time deposits which could not be offered on demand deposits in the low interest rate environment.

As Irish mortgage lenders increased their sophistication on the capital market in recent years, so their ability to offer fixed rate products improved. The popularity of fixed rate mortgages has increased greatly in the last five years. Meanwhile, following poor reports in the media on the performance of endowment mortgages, endowment's share of new residential lending dropped from 39% in 1992 to only 5% in 1996.

There are currently only 5 building societies still operating in the Irish market as the last decade has seen a number of mergers between building societies and the conversion of one building society to bank status.

1996 saw the first issue of mortgage backed securities by an Irish financial institution.

ITALY

I. General Description of the Market for Mortgage Credit

Until the end of 1993, the mortgage credit market in Italy was dominated by the specialised mortgage credit institutions. As of 1 January 1994 a new Banking Act came into force, introducing “universal banking” and thereby ending the traditional distinction between mortgage credit institutions and other banks. The new all-encompassing definition of credit institutions is now just “Banks”, any of which is allowed to grant mortgage loans.

Market shares by type of institution

Residential and commercial mortgage loans outstanding (% of total - End of 1996)

Banks	100%

Lending

Outstanding loans against residential and commercial property amounted to ITL 210,813 bln at the end of December 1996. Bearing in mind that at the beginning of 1995 the Bank of Italy adjusted the recording system of mortgage activity following the enforcement of the new Banking Act, statistical series may show inconsistencies.

II. Market developments during the past 10 years

The mortgage market development has been marked by changes in relevant regulations. The new Banking Act allows banks to choose the organisational model which best suits their strategies. In particular, each bank now has the chance to either specialise in a single business area or expand its activity towards the provision of the full range of financial services listed in the Appendix to the second Banking Directive and subject to mutual recognition within the European Union. The ultimate objectives are to increase the level of efficiency of banks and facilitate the emergence of larger banking groups which can compete internationally. With this in mind, mergers have been favoured among institutions with different operating experiences, so that synergy arising from the consolidation of different banking businesses can be exploited.

Also, the funding side of the banking activity has been de-specialised. Banks can now raise finance according to their general lending needs, without necessarily matching funding sources with any specific undertaking. All banks have been allowed to issue bonds. The new Banking Act has, moreover, eliminated the different categories of banking bonds, incorporating them in the general category of “obbligazione”.

Before the enactment of the Legislative Decree of 1 September 1993, no 385, the Italian mortgage market was dominated by long-term specialist institutions (ICSs). Among these, only nine operated on a national basis and the three largest (Sezione di credito fondiario-edilizio of Banca Nazionale del Lavoro, Sezione di credito fondiario-edilizio of S. Paolo di Torino and Sezione di credito fondiario-edilizio of Cariplo) originated more than 45% of total mortgage loans. At present, most of these lenders have merged with their “parent” bank or other ICSs. This trend is expected to continue in the future, with larger banks absorbing most of the ex-ICSs’ market share. Many studies on the sector agree that the ex-ICSs’ future is likely to be in the financing of large construction projects rather than in retail mortgage lending.

Following the rise of inflation in the second half of the 1970s and the consequent difficulties in the fixed rate bond market, ICSs focused on the reference rate bonds. This attitude was then reflected in the lending activity, whereby mostly reference rate loans were offered. Recently this trend has been reversed, due to the fall in inflation and the prospects for the EURO becoming more concrete. Eventually, this should favour the increase in the average maturity of mortgage loans offered (now ten years).

Another distinguishing feature of the Italian mortgage market in the past years was the high number of ECU denominated mortgages. Borrowers preferred the lower interest payable on ECU mortgages while believing the exchange rate risk to be small because of Italy's membership of the Exchange Rate Mechanism (ERM). The devaluation of the lira in 1993 and the following exit of Italy from the ERM have proved this belief to be wrong. Since then, the ECU mortgage market has fallen considerably.

LUXEMBOURG

I. General Description of the Market for Mortgage Credit

The volume of the Luxembourg mortgage credit market to private households (about 80% of the total volume) amounted to LUF 137.9 billion at the end of 1996. This type of credit is supplied primarily by the large universal banks. In view of the lack of specific legislation on the granting of mortgage loans, institutions specialising strictly in real estate financing are more or less non-existent in Luxembourg.

Market shares by type of institution

Residential mortgage loans outstanding (% of total - End of 1996)

	approx. %
Banque et Caisse d'Epargne de l'Etat	60
private commercial banks	25
cooperative bank (Caisse Centrale Raiffeisen)	8
pension funds	5
other	2
	100

Lending:

Variable interest is agreed in the vast majority of cases for loans secured by mortgage in Luxembourg. The stable condition of the capital market has however increased the readiness of banks to offer loans at fixed interest as well. A growing demand for 5 and even 10 year periods of fixed interest is to be observed against the background of the present favourable level of interest rates. Payment of compensation in the event of repayment of the loan before the expiry of the period of fixed interest may in principle be agreed freely. The Caisse de Pension des Employées Privés, as the largest supplier of mortgage loans in the non-banking sector, grants loans for specific purposes (in particular to buy housing) at special terms. Where the borrower becomes the owner of a dwelling to be owner-occupied on a long-term basis, the State grants interest subsidies and interest rebates depending on income and family situation.

Funding:

The universal banks use the customary refinancing instruments for medium to long-term loans, such as sight, savings and time deposits, cash vouchers issued on tap, bonds quoted on the Stock Exchange or placed privately. Mortgage-backed securities are not yet available on the Luxembourg market.

THE NETHERLANDS

I. General Description of the Market for Mortgage Credit

The Netherlands has one of the most liberal mortgage credit markets in the EU. Accordingly, the range of mortgage credit institutions and of mortgage credit products is very large, with the consumer having a wide choice of possibilities.

Mortgage as a security is attractive for all lenders - easy and fast procedures, computerised public information, generous government support for housing and interesting fiscal aspects for consumers. Mortgage lending is attractive for banks from the point of view of registration of customers; for insurance companies from the point of view of sale of life insurance policies; for pension funds from the point of view of investment (of premiums received) and for building funds from the point of view of selling houses built by them. The true specialists i.e. the Mortgage Banks concentrate on the top end of the market and commercial lending. Consumer protection in the field of mortgage credit is arranged through an extensive self-regulation arrangement to which virtually all lenders subscribe. To this end a representative organization was created in 1990: The Contactorgaan Hypothecair Financiers in Amsterdam.

Market shares by type of institution

Residential mortgage loans outstanding (% of total - End of 1996)

Commercial Banks	74.1%
Insurance Groups and Pension Funds	17.2%
Mortgage Banks and Building Funds	8.6%
Others	0.1%

Lending: The average new residential mortgage loan in 1994 amounted to 170,300 NLG (during the first quarter 1997 it amounted to NLG 186,000). Debtors may in general repay 10% extra per year without penalty for early repayment. Total early repayment is allowed without extra charge in the case of moving house or in the case of death of the debtor. Mortgage loans are in general at a reviewable rate of interest for terms between 5 -10 years. Combination of a mortgage loan and endowment insurance are common practice and favoured by the fiscal treatment of interest payments.

Most residential mortgage loans are arranged through intermediaries - estate agents and insurance-brokers. Local or regional bank branch networks are important for direct selling and to maintain relations with intermediaries.

Funding:

- Banks fund by collecting savings and accepting deposits. They also issue bank bonds.
- Mortgage banks, by virtue of their specific asset composition i.e. mortgage loans, fund partly through the tap-issue of specific mortgage bonds. These banks are, by law, restricted to bonds issued under private contracts; they cannot take short-term deposits from the public.
- Insurance companies and pension funds find their funding in the premiums received.

II. Market developments during the past 10 years

Because of the low level of interest rates, the period of fixed interest has become longer (12 years is very much in demand at the moment). Until about 1995 the sinking fund mortgage was the most current type. Since 1995 the improved endowment mortgage has become the most popular. Because of the continuing low level of interest rates, there is now a tendency to develop investment-based mortgages.

NORWAY

I. General Description of the Market for Mortgage Credit

The Norwegian mortgage credit market for private properties is dominated by the commercial, savings and state banks. The insurance companies also account for a relatively high percentage . Commercial banks and savings banks grant respectively around 33 and 40.8 per cent of total mortgage loan against residential properties at the end of 1996, while the remainder was granted by the state banks (16.1 per cent) and mortgage institutions (1.5 per cent).

Market shares by type of institution
Residential mortgage loans outstanding (% of total)

Savings Banks	40.8%
Commercial Banks	33.0%
State banks	16.1%
Mortgage Institutions	1.5%
Finance companies	0.3%
The Central Bank of Norway	0.1%
Insurance companies	8.2%

Lending:
Net mortgage lending has been increasing in recent years. This is mainly a result of an formerly overindebted household sector now having repaid much of its debt, a rather low interest level increased housing transactions and house prices as well as a willingness to borrow for housing purposes.

Funding:
Both commercial banks and savings banks use deposits as their main source of funding, which represent approximately 70 per cent of their total liabilities. Private mortgage credit institutions are not allowed to take deposits on account (not being defined as banks) but fund themselves mainly on the bond market. The State banks are mostly mortgage credit institutions and as such borrow directly from the treasury and to some extent on the capital markets. The state banks do not take deposits from the public and are not engaged in ordinary banking business.

II. Market developments during the past 10 years

In recent years, most of the former independent mortgage institutions have been bought by banks or transformed into banks. There is increasing competition in the market for residential mortgage loans. The liberalisation of the credit market during the 1980s increased integration and competition on the domestic market and competition from abroad.

PORTUGAL

I. General Description of the Market for Mortgage Credit

Three institutions traditionally specialising in mortgage credit have the largest market share.

Market shares [333]
Residential mortgage loans outstanding (% of total - End of 1996)

Caixa Geral de Depósitos	42.4%
Crédito Predial Português	12.3%
Montepio Geral	10.90%
Banco International de Credito	4.1%

CAIXA GERAL DE DEPÓSITOS
Lending: Mortgage loans in the field of the construction and purchase of housing, with a high percentage of subsidised loans.
Funding: The CGD operates like a universal bank. Funding is obtained through savings and time deposits.

CRÉDITO PREDIAL PORTUGUÊS
Lending: The CPP is a universal bank and is authorised to carry out all transactions. Despite its status, its balance sheet indicates that loans secured by mortgage (financing of housing and construction, covering all types of credit existing on the market) are a dominant activity.
Funding: All forms of funding: own funds, deposits and capital market.

MONTEPIO GERAL
Lending: Montepio Geral carries out all credit transactions. Its portfolio includes very significant outstandings for loans secured by mortgage for construction and housing purposes. Montepio Geral grants a large proportion of subsidised loans. Since the end of 1994, Montepio Geral has been authorised to carry out all international operations, which it was not previously entitled to do (foreign markets and foreign currencies).
Funding: Own funds, deposits and issues of subordinated bonds

COMMERCIAL BANKS
Lending: All types of credit.
Funding: All forms of funding.

II. Market developments during the past 10 years

The Portuguese financial system has undergone substantial structural changes mainly on account of the new legal framework adopted in 1992. This provides for the deregulation, liberalisation and internationalisation of banking.
Credit to private individuals and securing customer loyalty have become the strategic objectives of the majority of banks operating on the market. Competition is very keen in the housing credit sector

333 EMF Members

(subsidised and non-subsidised). The majority of the banking groups which have formed in recent years normally include a bank specialised in the property financing sector.

SPAIN

I. General Description of the Market fo r Mortgage Credit

The mortgage credit market in Spain is divided between the savings banks, commercial banks, co-operative banks and new financial credit institutions. The mortgage credit market was regulated by Law of 25 March 1981 and by the Royal Decree of 17 March 1982, which developed the issuing of mortgage bonds secured by mortgage loans for different types of institutions.

Market shares by type of institution

Residential and commercial mortgage loans outstanding (% of total - End of 1996)

Savings Banks	52.83%
Banks	39.24%
Co-operative banks	4.54%
Financial credit institutions*	3.39%

(market share of "other" institutions is not significant)

* Mortgage credit companies (MCC) disappeared and were transformed into new financial credit institutions from 1 January 1997.

COMMERCIAL, SAVINGS AND CO-OPERATIVE BANKS

Lending:
Credit secured by mortgage for financing acquisition, construction, repair and maintenance of dwellings and commercial and industrial premises; both variable and fixed interest mortgages are available with a term of up to 25 years.
Funding:
Sight savings and term deposit accounts, certificates of deposit, mortgage bonds, borrowing on the money market and mortgage backed securities.

MORTGAGE CREDIT INSTITUTIONS

Lending:
As mentioned for commercial, savings and co-operative banks
Funding:
Mortgage bonds, promissory notes (commercial paper) and borrowing on the money market

II. Market developments during the past 10 years

Since 1986 great changes have occurred on the Spanish mortgage market.
There has been spectacular growth in the volume of outstanding mortgage loans. The level at the end of December '96 was five times higher than that registered at the end of December '86. Real growth rates were particularly high in 1989 and 1990, reaching levels higher than 20%. The behaviour of mortgage loans have been much more dynamic than the overall total of loans to the domestic private sector. The proportion of mortgage loans in total lending has risen from 22.8% to 43.9%. This sustained growth has been possible due to various factors, but it is important to highlight in particular especially the sharp drop in interest rates, in particular since 1993, the prolongation of the loan duration, and the appearance of a wide range of mortgage products with very flexible characteristics.
A significant transformation has also taken place in the market share of mortgage lenders, due to the strong drive of the commercial banks. However, the mortgage credit institutions, traditionally the great specialists in the market, did not achieve the development hoped for and by the beginning of 1997 they had disappeared or been transformed into the new finance credit institutions. In 1992, the issue of mortgage-backed securities was regulated, and together with the issue of mortgage bonds, constitutes

the most common instrument specifically for funding mortgages. Nevertheless, the greatest percentage of funding continues to be customer deposits.

SWEDEN

I. General Description of the Market for Mortgage Credit

The specialised mortgage credit institutions in Sweden (most of which are owned by commercial banks) constitute the Membership of the European Mortgage Federation and grant about 80% of total mortgage credit. The remainder is granted by the banks and insurance companies.

Lending:
Mortgage credit institutions in Sweden grant loans both for residential and commercial purposes. Outstanding mortgage loans of lending institutions in Sweden increased to SEK 1 016 bln (ECU 117 490 mio) at the end of 1996.
At the end of 1996, outstanding mortgage loans of the Members of the European Mortgage Federation amounted to SEK 995 bln (ECU 115 100 mio).

Funding:
During 1996, mortgage bonds amounted to 77% of total funding of Swedish mortgage credit institutions. The second main source of funding is through short-term certificates. Swedish mortgage credit institutions are not allowed to take deposits on account, as legally they are not banks.
A growing share of the mortgage bond stock is denominated in foreign currency. Financing outside Sweden represents a long-term strategy to broaden funding of the mortgage credit institutions.

Banks and insurance companies
Lending: Both fixed and variable rate loans are available for the customers.
Funding: Principally through deposits and insurance premiums.

II. Market developments during the past 10 years

The Swedish market for mortgage credit has increased only modestly in the last few years. The relatively low growth of the Swedish economy, together with the high unemployment rates, has caused households to be careful about taking out new high mortgage loans. Another reason for the modest development of the Swedish mortgage credit market is the very low level of housing construction activity in Sweden. In 1986 there were 33 000 housing starts. In 1996 this figure had fallen to only 13 000 housing starts.

The Swedish economy is now however showing some substantial signs of improvement with low interest rates and economic growth. These variables, together with lower unemployment rates, will probably promote a more positive trend in the Swedish mortgage market in the coming years.

UNITED KINGDOM

General Description of the Market for Mortgage Credit

Traditionally, the UK residential mortgage market has been dominated by mutually-owned building societies. However, the situation has changed significantly during the past two years with many of the largest building societies choosing to convert to banks Among the reasons given for converting have been the wish to avoid the former prescriptive nature of building society legislation, to diversify further within the financial services sector and to enhance access to capital. A small number of building societies have been acquired by larger banks.

The majority of the planned conversions had taken place by the end of July 1997. The table below shows the impact conversions have had on the relative importance of banks and building societies.

Market shares by type of institution
Residential mortgage loans outstanding (% of total)

	End 1996	End July 1997
Building Societies	54.7	24.9
Banks	38.7	68.6
Other Specialist Lenders	5.9	6.0
Other	0.8	0.5
TOTAL	100.0	100.0

Source: Bank of England

Mortgage Lending

The mortgage market has become progressively more competitive since deregulation of the financial sector in the early 1980s. A protracted recession in the housing market in the first half of the 1990s triggered a fresh wave of consolidation within the sector, with many of the specialist lenders set up in the mid-late 1980s closing to new business or being sold to longer-established businesses.

Aggressive competition saw the emergence of deep discounting for new business and intense competition between lenders for existing mortgage business (remortgaging), although these practices have eased back as the housing market has improved. Competition has also spawned new distribution channels, including direct telephone selling.

The majority of building society loans made are secured by way of mortgages on residential property for owner-occupation. Currently, about 77% of societies' assets comprise residential mortgage loans, with most of the remainder comprising liquidity. A more permissive regime for building societies allowing wider diversification of their businesses has been introduced under the Building Societies Act 1997.

A voluntary code aimed at promoting good practice in respect of the mortgage selling process - including the provision of advice to customers and relations with the borrower over the life of the loan - was adopted by mortgage lenders in mid-1997.

Mortgage Funding

The majority of institutions fund their mortgage lending through both retail and wholesale markets. Reflecting legislative restrictions on building societies - they have to raise at least 50% of their funding from retail sources - longer-established banks are more reliant on wholesale funding than remaining and newly converted former building societies. At present, about 20% of building society funding comes from wholesale sources.

C. GLOSSARY OF ECONOMIC TERMS

Adjustable Rate Mortgage Loan. An adjustable rate mortgage loan is a mortgage loan that allows the interest rate to be changed at specific intervals over the maturity of the loan. The definition comprises reviewable rate and variable rate mortgages. Typical intervals are three to six months. In reviewable rate schemes the adjustments are undertaken unilaterally by the mortgage lender, in general against refinancing cost-related indices such as a cost-of-funds index, the three- or six-month treasury bill rate, and others. Often, adjustable rate instruments are vested with interest rate caps as a protection for the borrower against interest rate risk. Caps are frequent in the U.S. but less common in Europe.

Annuity. Investment contract making a series of payments over a period of time, for a fixed number of years.

Bond. Financial instrument, often negotiable, used to borrow funds with a maturity of longer then one year.

Building Society. A type of specialized housing bank well developed in the U.K. The 100 Building Societies collect most of their resources from the general public through savings accounts and term deposits; they use these funds to grant mortgages. The interest rates paid for the savings and received on the mortgage are variable, depending on the conditions of the market; they are adjustable periodically by the building societies. In their two centuries of experience, Building Societies have financed more than 80% of the houses in the U.K. However, since new financial institutions have come on the market in the 80=s, their share has been reduced to about 50%. They are presently diversifying their activities out of the strict mortgage market.

Call Option/Callable Bond. A call option is a right to purchase (sell) an asset at (for) a fixed price, valid over or after a specified time period. A callable bond is a debt instrument endowed with an option of the issuer for partial or full redemption to its nominal value before final maturity. Callable bonds may be understood as a combination of a non-callable (straight) bond and a call option by the issuer. Callable bonds have specific relevance in the presence of call options of borrowers (e.g., prepayment option).

Collateral. Asset pledged as security to ensure payment or performance of an obligation. In bank lending, it is generally something of value owned by the borrower. If the borrower defaults, the asset pledged may be taken and sold by the lender to fulfill completion of the original contract. When bank assets are securitized directly, or converted in to marketable securities in the secondary market, the principal and interest payments serve as collateral for the securities offered for sale to investors. Examples are mortgage bonds or mortgage-backed securities, which are backed by residential mortgages.

Commercial Bank. A financial institution which provides a variety of financial services including consumer and business loans (generally short-term), financed essentially with resources raised through checking and savings accounts.

Construction Loan. A loan that finances the housing developer during the time of construction (for 1-3 years), or subdivision costs and improvements to real estate. The bank (either a commercial bank or housing bank) agrees to open a line of credit with a ceilling amount; as construction progresses the developer withdraws funds as needed. When the work is completed, the developer uses the money he receives from the buyer (who themselves have obtaines mortgages) to repay this loan. He "consolidates" the construction loan.

Contractual Savings System/Bausparen. In these systems savings are deposited regularly by a customer into a specific bank account; most often, a precise monthly amount is defined in a contract between the banker and the customer. When the target sum has been reached at the end of the saving period, the banker grants a predetermined loan, most often a second mortgage. In its closed form (German Bausparen), lenders guarantee a fixed loan rate spread over the savings rate; however, due to cyclical savings behaviour borrowers may have to wait for loan. In its open form (French Epargne-Logement), there are no waiting periods, but rates vary with the capital market situation. The German Bausparkassen system in addition imposes strict regulation on institutions undertaking contract savings. As a special form of contractual savings schemes it has been implemented in several countries, at present: Austria, Germany, the Czech Republic, Slovakia, Poland and Hungary.

Discounted Cash Flow Method. Accounting technique for estimating the present value (market value) of anticipated future income and expenditures, such as earnings from loan principal and interest payments, and income from investment secuititites. It is calculated as either net present value, which expresses future cash flows in terms of current money by applying a discount rate to future receipts, or internal rate of return, which figures that average annual yield or return on capital of an investment or a bank loan over its expected lifetime.

Financial Intermediary. A financial intermediary is any kind of institution that enables an indirect flow of funds between capital surplus (eg. households) and capital deficit agents (eg.firms).

Fixed Rate Mortgage Loan. Fixed rate mortgage loans have fixed interest rates for a specified period. They are generally constant payment, fully-amortizing loans, implying that the payment includes a principal repayment and an interest rate payment component. As a consequence of repayments, the loan balance decreases over time, making the interest due decrease as well.

Interest Rate Cap. An interest rate cap is a contractual limitation of the (adjustable) interest rate of a mortgage loan. Capping the rate shifts part of the interest rate risk from the borrower to the lender, against a price to be paid by the borrower.

Intermediary/Intermediation. An intermediary is a financial institution, such as a bank or savings and loan, that acts as a conduit between suppliers of funds (depositors) and users of funds (borrowers). Intermediation is the process of transferring funds from an ultimate source to the ultimate user. A bank intermediates credit when it obtains money from a depositor and re-lends it to a borrowing customer.

Liability. A legally enforceable claim on the assets of a company, excluding owner's equity, or the property of an individual, calling for a transfer of assets at a determined future date. Also, any item appearing on the right hand side of a double-entry accounting system or balance sheet.

Liquidity. Ability of an organization to meet its current financial obligations. In banking, adequate liquidity means being able to meet the needs of depositors wanting to withdraw funds and borrowers wanting to be assured that their credit or cash needs will be met. Liquidity is also measured in terms of debt capacity or borrowing capacity to meet short-term demands for funds.

Maturity Transformation/Matched Maturities. One of the key functions of retail banking is (positive) maturity transformation, ie. the use of short-term liabilities (eg. deposits) to finance long-term assets (eg. long-term loans). Maturity transformation entails both substantial profits and risks for the lender.

On the other side, matching maturities of assets and liabilities means eliminating maturity transformation and the embedded risks (as long as the duration of assets and liabilities remain known in advance), but typically also reduces potential profits. One approach of matching maturities is matched wholesale funding (eg. securitization), another is combining short-term retail funding with hedging instruments (eg. swaps) to match the characteristics of the long-term assets.

Mortgage Bank. These banks specialize in housing; they grant mortgage loans, cash the periodic repayments, and whenever needed sell them on the mortgage market. However, they do not raise funds from the general public the way commercial banks do through a large network; they only raise their funds on the financial markets.

Mortgage-Backed Securities (MBS)/Mortgage Bonds (Securitization). Mortgage-backed securities are backed by a pool of mortgages or trust deed. Mortgage bonds, in addition, are a full liability of the issuer.

Principal and interest payments on the underlying mortgages are used to pay interest and principal on the securities. Most mortgage-backed securities, such as collateralized mortgage obligations and real estate mortgage income conduits, consist of multiclass obligations that are divided into different classes of bonds to appeal to different investor needs. Because some mortgage pools will pay off faster than others, mortgaged-backed securities are typically issued as a series of several different bonds, each having a different maturity date. Instead of being a direct liability of the issuer, MBS are issued off-balance, typically with external credit enhancement. Some European countries have special legislation for MBS issuances.

A mortgage bond is an important special case of mortgage-backed securities, in that the bonds are issued on balance. In this case the mortgage bank remains the full financial intermediary between investors on the capital market and borrowers. Legal provisions typically require the claim of a mortgage bond creditor to be separated from the other assets of a bankrupt, i.e., bond creditors usually have a first claim on the underlying assets. Other safety measures apply, which are typically laid down in special legislation.

Off-Balance Sheet Items. Obligations that are contingent liabilities of a bank, and thus do not appear on its balance sheet. In general, off-balance sheet items include the following: direct credit substitutes in which a bank substitutes its own credit for a third party, including standby letters of credit; irrevocable letters of credit that guarantee repayment of commercial paper or tax-exempt securities; risk participations in bankers' acceptances; sale and repurchase agreements; and asset sales with recourse against the seller; interest rate swaps; interest rate options and currency options, and so on.

Prepayment/Prepayment Penalty. Mortgage prepayment is the paying off part of or the entire loan prior to the maturity laid down in the loan contract. The motives of prepayment are typically categorized into Afinancial≅ (eg. favourable refinancing rate) and Anon-financial≅ (eg. sale of house, inheritance). A prepayment penalty is a fee paid to a lender for the right of prepayment. It is intended to compensate the lender for loss of income in future years, and to reduce the probability of prepayment by increasing the costs for borrower.

Principal. Face amount of a loan evidencing the amount repayable, exclusive of interest, according to the terms of the note securing the obligation.

Saving and Loan Association. Saving and Loan Association (S&L) were the ≅housing banks≅ in the USA. They appeared in the 1830s as a substitute for commercial banks which served almost exclusively commercial enterprises, while loans to individuals for private housing were virtually unknown. Originally an association in which ≅members≅ invested their savings and borrowed for home purchase, the S&L=s have become large financial institutions, developing new savings instruments and expanding their lending out of the housing business. They are presently facing difficulties due to a combination of various reasons, one among which being the restriction to adjust their rates up until they were deregulated in the 1980s.

Savings Bank. Created at the end of the 19 th century, savings banks deal mostly with households. They usually collected modest amounts of savings from the general public and sometimes granted small personal loans or mortgages. They have had an impressive record in attracting newcomers to simple financial mechanisms. For the last decade, the savings banks in Western Europe have embarked on a substantial reform to become progressively full-fledged universal banks.

Secondary Mortgage Market. This market is a set of mechanisms available to buy and sell mortgages. The secondary mortgage market in the USA involves three man financial institutions: FNMA, Freddie Mac and Ginnie Mae. Fannie Mae holds auctions weekly to buy those mortgages offered by mortgage or commercial banks in need of liquidity. Freedie Mac, not only buys mortgages, but resells them to investors; it also creates specific instruments which are securities backed by pools of mortgages kept by the seller. Ginnie Mae provides the securities with a ≅cash-flow≅ insurance which is a guarantee that the repayments will be passed to the investor on due date, whether paid or not to him by the borrower. The secondary mortgage market has expanded dramatically since the crisis of 1980 - 82, when thrift institutions simultaneously faced a disintermediation problem and an interest rate problem. This market has given the prime lenders the opportunity of passing their main risks to final investors, with the guarantee of the public conduits. The existence of the secondary mortgage market in the USA was necessitated by the segmentation of the market (both geographically and institutionally) and the absence of a unique central supervisory body (Central Bank-type).

Spread. The percentage difference between the interest rate charged on a bank loan and the lender's cost of funds.

Swap. Agreement to exchange interest payments in a fixed rate obligation for interest payments in a floating rate obligation (an interest rate swap), or one currency for another (a currency swap), and reverse the exchange at a later date. A cross-currency swap is the exchange of a fixed rate obligation in one currency for a floating rate obligation in another. A swap agreement is based on a notional principal amount, or an equivalent amount of principal, that sets the value of the swap at maturity, but is never exchanged. The notional principal sets the value of the interest payments in a swap. Interest rate and currency swaps are used by bankers and investment managers to minimize borrowing costs, to fund bank loans with liabilities of approximately equal durations, to gain liquidity (in a currency swap) in one currency versus another; to hedge portfolio risk or raise capital in foreign markets; and also to generate trading profits.

Swaps most often are used for funding purposes or for creating assets, and have some advantages when compared to bank loans or deposits in asset-liability management. Unlike loans or deposits, swaps are not disclosed on the balance sheet of the issuing bank, although banks must still reserve a portion of their equity capital to cover their outstanding swap agreements under risk-based capital guidelines.