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EXECUTIVE SUMMARY

REPORT

OF THE MORTGAGE FUNDING EXPERT GROUP

DISCLAIMER

The views expressed in this report are the views of the Expert Group and its members, and not of the European Commission.

Commission européenne, BE-1049 Bruxelles / Europese Commissie, BE-1049 Brussel - Belgium. Telephone: (32-2) 299 11 11.
Office: C107 00/07. Telephone: direct line (32-2) 296 20 91. Fax: (32-2) 295 07 50.

http://ec.europa.eu/internal_market/
E-mail: markt-h3@ec.europa.eu

1. EXECUTIVE SUMMARY

1.1. Background

The origination and funding of mortgages are intrinsically linked. The supply of mortgage credit products and the price at which they are offered relies heavily on an individual institution's funding strategies. This close relationship means that the integration of European mortgage funding markets can facilitate increased efficiency, improved product diversity and a higher degree of competition. Further integration of the EU mortgage markets could, therefore, be considerably enhanced by the emergence of a pan-European funding market.

The Mortgage Funding Expert Group (MFEG) was established in April 2006 to:

- identify the barriers to integration for each of the funding models outlined in the Mortgage Forum Group Report from December 2004;
- prioritise the barriers identified in terms of their significance to the market;
- consider and justify possible solutions for each of the barriers identified and make concrete recommendations to the Commission.

The Expert Group was carefully selected to ensure a balance between the different stakeholders involved in the funding process including originators, investors, ratings agencies, and investment banks. Experts represent all funding techniques (covered bonds, mortgage-backed securities, deposits, etc.) and most EU mortgage markets.

- This report summarises the discussions held and presents the recommendations of the experts participating in the Expert Group. The report does not represent the views of the Commission, which will be set out in a White Paper in 2007.
- The report has resulted in a series of recommendations, which the Commission is asked to review. These recommendations are based on a vision for an integrated European mortgage funding market.

1.2. Vision

European mortgage funding markets are already relatively efficient. Targeted measures can, however, further improve their operation leading to greater integration. MFEG believes that a market-based, deregulated approach is best able to provide efficient markets, deliver maximum choice and best pricing for the consumer.

An integrated European mortgage funding market should satisfy five criteria: it should be complete, competitive, efficient, transparent and stable.

1.2.1. Complete

A balanced approach to funding mechanisms is required. It is important for each market to be able to retain its own banking and mortgage financing model where it serves the interest of different borrower and lender requirements as well as the demands of domestic and international investors.

- Mortgage lenders should be free to choose the most appropriate funding strategy for their business and have equal access to mortgage funding markets and investors irrespective of their location.
- Regulation should not favour one form of funding above another, since each funding instrument has its own advantages and disadvantages based on its particular product characteristics.

1.2.2. Competitive

The integration of European mortgage funding markets is an opportunity to generate new business opportunities as well as to promote competition in the market by enabling new companies to enter markets. Capital markets funding enables originators to offer the most competitively priced funding available from any global investor, to complement existing local funding sources. To maximise its benefits, competition should occur at every stage in the mortgage value chain: origination, underwriting, funding, servicing, and risk processing.

- MFEG welcomes measures to promote the development of alternative distribution channels for mortgage origination. To this end, MFEG supports the Commission's intention to undertake a focused study on credit intermediaries in 2008.
- Where a servicer or non-bank originator is authorised in one EU Member State, it should be automatically authorised to do the same business in all other EU Member States, subject to minimum notification or registration requirements. The Commission should examine creating a 'passport' for non-bank originators and servicers.
- Member States which require banking licences for residential mortgage lenders should limit the amount of regulation on non-deposit taking institutions to an appropriate level, commensurate with the risks with respect to capital and funding. Member States should ensure that legislation does not require servicers to hold a banking licence.
- Member States should ensure that legislation, including securitisation laws, should not prohibit or restrict the cross-border servicing of assets – if that is the model chosen by the lender.
- The Commission should ensure that public mortgage related activities are restricted to purely social, or other promotional purposes, within the context of Article 87 of the Treaty.

1.2.3. Efficient

The efficiency of European mortgage markets can be improved through the existence of more liquid and diversified markets. Caution should, however, be exercised to ensure that possible negative side effects do not ensue. The focus of efficiency related measures should be on deregulation and market based solutions rather than across the board standardisation of mortgage products.

1.2.4. Transparent

Given that full scale standardisation would not only be difficult but also questionable in its effects, transparency plays a crucial role in facilitating investor understanding of the product and funding diversity. Transparency will increase the efficiency and comparability of funding markets across Europe.

1.2.5. Stable

The efficient allocation of risk in the market is crucial. Long-term funding from capital markets adds stability to mortgage markets across Europe.

- MFEG recommends that EU and national regulators promote funding and risk transfer alternatives, which encourage market and institutional stability and remove the obstacles mentioned in this report.

1.3. Primary Markets

1.3.1. Early Repayment

Early repayment (prepayment) of a mortgage loan can create a number of consequences for the mortgage lender or investor in the mortgage. The consequences of early repayment depend on several factors, such as whether the mortgage loan is a fixed or a floating rate loan, how the funding for such loan is raised and the costs of selling the loan to the borrower (e.g. marketing and commission costs). If a consumer repays a loan earlier than scheduled, the mortgage lender will not be able to generate the expected income and will incur a loss. If a mortgage lender has raised funding with a stated maturity and coupon or has hedged the mortgages, the mortgage lender must replace the mortgage or break hedging arrangements which might prove expensive or even impossible. From the perspective of the investors, the early repayment of underlying mortgages in the collateral pool may lead to an earlier than expected repayment of their bonds. This may lead to losses for investors.

Prepayment has been regulated to varying degree across the EU. Furthermore, some legal interventions have covered several aspects of prepayment, namely, whether consumers have a right to repay early or not, and whether compensation should be payable and how much. MFEG believes that such legal interventions into prepayment policy have often led to unacceptable distortions in mortgage loan pricing and cross-border lending activity.

In this context, MFEG agreed the following:

- Prepayment is a cost to the lender, which can be addressed by an interest rate mark-up, by a variable compensation or by a predetermined fee. There should be no free right to prepay.
- The compensation formula should be clearly established, transparent and easy to understand for the consumer.
- Early repayment charges should not be subject to any further constraints through limitations via hardship cases or through the imposition of caps or waivers.

- Lenders and investors should develop prepayment models to better value the prepayment option in order to meet consumer demand for a less costly prepayment option. To do so, lenders should ensure that information on prepayments becomes more readily available.

1.3.2. Property Valuation

Property valuation affects mortgage funding in four ways. First, for banking supervision, the preferential risk weight of mortgage loans under the Capital Requirements Directive (CRD) requires consistent property valuation in order to define the part of the loan which is eligible to the preferential treatment. Second, in terms of covered bond funding, consistent property valuation and loan-to-value ratios are one of the core eligibility criteria of mortgage assets being accepted as cover assets and any national covered bond legislation refers to property valuation as a fundamental criterion for the safety of the covered bond instrument. Third, for RMBS transactions, any rating of RMBS transactions requires a valuation of the mortgage assets to be securitised. Fourth, for whole loan sales, mortgage portfolio trading relies on consistent portfolio valuation and property valuation techniques. The importance of consistency and disclosure is particularly acute where cross-border transactions are being considered.

At a Member States level, property valuation is characterised by a huge diversity with respect to valuation rules and valuation traditions. Against this background, MFEG agreed the following:

- Convergence in valuation principles and professional requirements should be achieved through a Recommendation rather than through binding EU regulation.
- There should be a greater disclosure of valuation methods and the development of a common definition of basic technical terms in order to aid transparency.
- Common standards should be adopted for the professional qualification of property valuers.

1.3.3. Land Registration

Procedures for constitution and registration of the mortgage may influence European funding markets in several ways. First, the easy transferability of mortgages is essential for the emergence of a European secondary market. In some Member States, the transferability of mortgages requires the registration of a new mortgage deed. Inefficient and costly registration procedures are thus a potential barrier to the emergence of a secondary market. Second, although the vast majority of Member States have electronic mortgage registers, on-line registration is only accessible in approximately half the Member States. Third, non-registered mortgages and preferences (hidden charges) exist. The scope and size of these charges is uncertain and can endanger the security of the funding instrument.

With these problems in mind, MFEG agreed the following:

- The Commission should ensure that mortgage loan portfolios are transferable to a new lender in all Member States without registration of a new mortgage deed for each loan in the transferred portfolio. Furthermore, the Commission should ensure that the transfer of a mortgage loan is not subject to the acquiescence or consent of the borrower if the loan conditions are not altered to the disadvantage of the borrower.
- The Commission should ensure equal access to mortgage registers in all Member States for domestic and foreign lenders thereby creating a level playing field. In this respect, the development of central and dematerialised registers should also be encouraged.
- In order to enhance transparency, the Commission should recommend the discontinuation of hidden mortgages and preferences.

1.3.4. Foreclosure Procedures

Inconsistent and lengthy foreclosure periods in Member States create uncertainty for investors as well as lenders and ultimately drive up the cost of borrowing to the consumer. In certain cases, this may discourage lenders from entering new markets, thereby limiting consumer choice. Furthermore, significant differences in efficiency of enforcement procedures amongst Member States add complexity to the valuation and risk assessment of cross-border loan portfolios.

Against this background, MFEG recommended that:

- The Commission should undertake a study to determine best practices for enforcement procedures in all Member States and develop a scoreboard to encourage convergence toward best practice. A maximum target for the duration of legal enforcement procedures should be set.

1.3.5. Data Protection

Directive 95/46/EC on the Protection of Individuals protects consumers against inappropriate distribution of information to third parties without their consent. This creates several problems with respect to mortgage funding. First, the requirement to obtain the data subject's consent for data processing is relevant in a funding transaction where assets and their servicing are transferred between originators and third parties, including lenders and servicers. This need for borrower consent has been implemented differently by Member States: some require the explicit authorisation of the data subject whereas in others, a tacit consent following the receipt of a notification of the data transfer suffices. These requirements can be costly and time consuming and may deter the development of mortgage funding markets. Second, at present, it is impossible for any investor in Europe to analyse credit characteristics, credit performance and prepayment on a detailed loan-by-loan basis. This is due to the broad definition of "personal data". This lack of detail prevents many investors from purchasing RMBS, which raises borrowing costs due to uncertainty.

With these issues in mind, MFEG recommended the following:

- The transferral of personal data between originators and third parties, including lenders and servicers, that have a legitimate professional reason to review the data should be permitted. The receiver must, however, treat the information confidentially.
- It should be possible to disclose personal data, excluding borrower's name or address, to investors for the purposes of investment decisions.

1.4. Secondary Markets

Many of the issues addressed under Primary Markets and Investor Issues apply to several mortgage funding instruments such as covered bonds, RMBS, temporary warehousing facilities and whole loans sales. This section deals only with instrument specific recommendations.

1.4.1. Covered Bonds

MFEG has identified several potential improvements to certain aspects of covered bonds, which would create benefits for consumers, lenders and investors. First, covered bond laws impose specific limitations on the type of assets that could serve as eligible collateral in cover pools. These exclusions limit the ability of issuers to diversify their cover pools in terms of collateral types. Second, tax matters associated with the transfer of loan portfolios as well as the interest flows derived from them are clearly a barrier to cross-border transfer of and/or funding of portfolios.

In this context, MFEG recommended the following:

- Member States who do not yet have covered bond legislation for all mortgage lenders should consider introducing one.
- Non-domestic EU mortgage loans should be accepted as eligible assets in cover pools. Any modification in the base of eligible assets should be designed in a way that ensures a high credit standard in the European Covered Bond issuance legal frameworks.
- The tax implications of cross-border mortgage origination and sales should be brought into the tax harmonisation policy discussions/decisions. This should also be considered when renewing bilateral tax treaties.

1.4.2. Residential Mortgage Backed Securities (RMBS)

MFEG highlighted several issues relating to RMBS issuance. Many of the barriers identified in RMBS also apply to temporary warehousing facilities. First, RMBS issuance volume has been significant both in countries with and without securitisation laws. However, in many countries there are still significant obstacles caused by inflexible legal frameworks. MFEG examined and endorsed ten principles, established by the European Securitisation Forum (ESF), for integration into all existing and future national securitisation frameworks to enhance flexibility and provide the lowest possible cost of mortgage funding to originators by maximising investor interest. In addition, most existing securitisation laws merely contemplate the transfer of assets to the local securitisation SPV and, thus, it is unclear whether the special provisions regarding taxation, bankruptcy remoteness or ring-fencing also benefit transfers to off-shore SPVs.

Against this background, MFEG recommended that:

- All Member States with existing securitisation laws, as well as those Member States considering the enactment of securitisation laws, ensure that their legal framework is based on the ESF's 10 broad Principles.
- Member States should be mindful of the implications of various taxes on the overall costs of securitisation when setting these policies.
- The Commission should create a broad concept of “recognised securitisation SPV” along the lines of the securitisation special purpose entity’s definition in Article 4(44) of the CRD. The Commission should also clarify that a transfer of assets to a “recognised SPV” will not be deemed a “detrimental act”.
- The UCITS Directive should be amended so that investment funds can invest up to 25% of their assets in AAA rated RMBS of a single RMBS issuer.

1.4.3. Whole Loan Sale

Whole loan sales are an efficient funding source for mortgage lending. MFEG therefore recommended that:

- Whole loan sales should be afforded the same treatment as the other funding instruments for mortgage lending.

1.5. Investor Issues

1.5.1. Definitions

As funding markets have developed on a piecemeal basis across Europe, the extent to which information on the underlying collateral is available to investors can vary significantly. Even when information is provided, issuers may have different definitions of the default, delinquency or recovery rates as well as loan to value ratios. A lack of standard definitions can sometimes result in information which may initially seem comparable actually being quite different. The lack of clear definitions makes it difficult to compare transaction performance and hence to calculate prices. This may lead to an increase in funding costs in markets where data is scarce or unreliable, or even to investors not participating in certain jurisdictions, as they are unable to verify key information regarding their investments.

Against this background, MFEG recommended:

- The development of market-driven standardisation of some of the key terms used in secondary markets. These standards would be used for monitoring the performance of a transaction and promoting transparency.

1.5.2. Reporting

A lack of consistency in the information disclosed to investors on collateral pools, RMBS tranches, and to some extent, covered bond pools is an obstacle to transparency. Greater standardisation of the means of issuing and disseminating information on the collateral which supports funding should therefore be encouraged.

With this in mind, MFEG recommended:

- Reporting standards for covered bond pool information should be developed by the market on the basis of best practice.
- Private sector standardised reporting initiatives for RMBS, such as the ESF “Securitisation Market Practice Guidelines”, should be encouraged.
- MFEG believes that the use of issuers' websites for post issuance reporting, as the most accessible method, should be encouraged.

1.5.3. Basel II

The CRD needs to be transposed into Member States' national legislation by end 2006. In doing so, Member States may follow different transposition routes, which could lead to varying degrees of regulatory capital relief for identical products. MFEG is increasingly concerned that a number of areas where the CRD is unclear or leaves discretion to national regulators may result in differences in interpretation and application among jurisdictions and firms.

In this context, MFEG recommended that:

- The issuance of CRD transposition guidance by the Commission, in particular, on the definition of significant risk transfer; implicit support and revolving structures; treatment of swaps with SPVs; and liquidity facilities, should be encouraged.
- The Commission should allow senior RMBS to constitute 100% of the cover assets for covered bonds, and confirm the AAA RMBS eligibility as cover assets for covered bonds beyond the 2010 CRD deadline.

1.5.4. Property Indices

Official house price indices do not exist in most EU countries. The development of a nationally recognised property index is extremely useful for mortgage funding and portfolio purchases. The creation of a property index that could eventually become tradable would allow lenders to hedge real estate exposures and promote other products and concepts, such as the provision of Equity Release products for elderly customers.

Against this background, MFEG recommended:

- The development of national house price indices across EU Member States should be encouraged. This would assist in the provision of more accurate valuation information, increase the efficiency of collateral in all forms of capital market funding under consideration, and help to manage the exposure to real estate price risk through the development of derivative markets.

1.5.5. Selling Restrictions

A number of issues were identified which were not felt to be critical barriers to funding but did create a number of unnecessary obstacles for investors in certain Member States. These involved a variety of selling restrictions, additional listing requirements and differing withholding tax rules.

MFEG therefore recommended that:

- Selling restrictions on securities, which are not helpful to creating a consistent funding market across the EU, should be removed.