EUROPEAN CENTRAL BANK

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THE EUROPEAN COMMISSION'S GREEN PAPER ON MORTGAGE CREDIT IN THE EU

EUROSYSTEM CONTRIBUTION TO THE PUBLIC CONSULTATION

INTRODUCTION

The European Central Bank (ECB) hereby provides a contribution to the European Commission's Green Paper on Mortgage Credit in the EU (COM (2005) 327). These remarks reflect the views of the Eurosystem, which comprises the ECB and the national central banks of the countries that have adopted the euro.

In general, the Eurosystem welcomes the Commission's initiative regarding the European mortgage market. The importance of this retail market segment is not least evident from its size (e.g. the outstanding volume of more than EUR 4 trillion in residential mortgage debt in the EU corresponds to around 40% of EU GDP).

The contribution is organised as follows: in the next section, the Eurosystem's interest in enhancing European financial integration is explained; the subsequent sections cover relevant issues related to the ECB's core tasks, namely the conduct of monetary policy and the contribution to the stability of the financial system, as well as issues related to the funding of mortgage credit from a financial integration perspective.

1 The Eurosystem's interest in European financial integration

The Eurosystem's interest in European financial integration is founded on three basic reasons. First, a well-integrated financial system enhances the smooth and effective transmission of monetary policy impulses throughout the euro area. This is relevant for the conduct of monetary policy, which is the basic task assigned to the Eurosystem under the Treaty establishing the European Community ("the Treaty").[1] Furthermore, while the integration of the money market, including the efficient functioning of large-value payment systems, is well advanced, further integration of capital markets, covering inter alia aspects such as the availability of financial instruments, the liquidity of markets in such instruments, as well as the integration of the related securities infrastructure, is of importance for the implementation of the single monetary policy.

[1] In accordance with Articles 4(2), 105(1) and 105(2) of the Treaty, the primary objective of the definition and conduct of the single monetary policy, which is a basic task of the Eurosystem, shall be to maintain price stability.

Second, financial integration has implications for the Eurosystem's task of safeguarding financial stability in the euro area and the EU, as laid down in the Treaty.[2] The pursuit of financial integration can have very beneficial effects on financial stability as more integrated financial markets could provide the necessary conditions for the smoother absorption of financial shocks. It may also help financial institutions to better manage and diversify their risks and realise economies of scale, which may, in turn, lead to greater efficiency. At the same time, it is necessary to closely monitor the profound changes in the nature of financial stability challenges due to the structural transformation of the financial system, including the strengthening of cross-border links. Moreover, cyclical challenges such as speculative periods on the real estate market should also be kept in mind.

Third, financial integration can generally help to promote the development of financial markets, institutions and infrastructures, thereby helping to support economic activity and to raise the potential for economic growth. According to the Treaty, the Eurosystem shall "without prejudice to the objective of price stability, […] support the general economic policies in the Community".[3] The Eurosystem is fully committed to supporting the general economic policies of the Community, with a view to contributing to achieving its objectives. This includes financial integration, which is a priority Community objective.

On a more general note, the Eurosystem furthermore recalls that, according to the Treaty, it "shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources".[4] This underpins the Eurosystem's view that financial integration is first and foremost a market-driven process.[5] Still, with regard to the process of financial integration, the Eurosystem sees it as a basic task of public authorities to create a framework conducive to fostering financial integration. If the opportunities thus created are exploited by market forces, true financial integration is achieved and its benefits can be reaped.[6]

The Eurosystem therefore welcomes the initiative of the European Commission to launch a broad discussion about the means to further integrate European mortgage markets. The Eurosystem understands that this initiative is in line with the priorities identified by the European Commission for financial services policy over the next five years, which are based on the assessment that integration is generally lagging behind in the area of retail financial services.[7]

2 Transmission of monetary policy

The financial system is essential for the transmission of monetary policy in the euro area, which is the basic task assigned to the Eurosystem under the Treaty. A well-integrated financial system is therefore of particular importance for the Eurosystem. Integrated and efficient financial markets enhance the smooth

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[2] Article 105(5) of the Treaty sets out the statutory task of the Eurosystem to contribute to the smooth conduct of policies pursued by the competent authorities on the prudential supervision of credit institutions and the stability of the financial system.

[3] See Article 105(1) of the Treaty.

[4] See Article 105(1) of the Treaty.

[5] In this respect, the Eurosystem also supports the European Commission's intention to set up a working group which could, among other things, identify issues that can be addressed by market-led initiatives.

[6] For the monitoring of financial integration in the euro area, see also the ECB report "Indicators of financial integration in the euro area", September 2005 (http://www.ecb.int/pub/pdf/other/indicatorsfinancialintegration200509en.pdf).

[7] See http://www.ecb.int/pub/pdf/other/ecgreenpaperfinancialservicespolicy2005en.pdf.

and effective transmission of monetary policy, which is the process through which monetary policy decisions affect the economy in general and the price level in particular.[8] The higher the degree of financial integration, the more effectively this transmission will work in practice.

In Europe, it seems fair to say that important progress has been made in the integration of money and bond markets, but further progress can be achieved particularly with respect to retail banking services, including mortgage lending. In this context, the Eurosystem has an obligation to encourage financial integration, including in the mortgage market, while carefully monitoring its consequences for monetary policy.

The implications of the integration of the mortgage market from a monetary policy perspective may stem from differences in institutional arrangements (financial, economic and legal structures) that potentially cause differences in the way in which monetary policy is transmitted to the economy across the countries of the euro area. On the one hand, heterogeneity of national structures may be of concern to the extent that differences arise as a consequence of a lack of competition or market entry restrictions, which may hinder the supply of products. On the other hand, country differences reflecting heterogeneity in preferences should not be seen as a matter of concern.

There are a number of examples of institutional differences relevant for the integration of the mortgage market and for monetary policy. These include product heterogeneity, such as the degree of variable rate versus fixed rate financing and the (legal) possibility of refinancing without additional costs, as well as housing equity withdrawal.

Clearly, variable rate mortgage loans, where the interest rate is reset frequently in line with market interest rates, would translate into a faster response of the disposable income of households to changes in monetary policy. Thus, these variable rate loans effectively establish an additional channel through which interest rate changes affect consumer spending. At the same time, a variable rate mortgage loan may carry the risk that the borrower will attach a greater importance to the current level of short-term interest rates, even though the vast majority of mortgage loans are extended for ten years or more. Past experience of industrialised countries does not support the notion that countries where the mortgage stock is predominantly at variable rates are those where monetary policy is more effective.[9] Monetary policy will be easier to manage if households make well-informed and forward-looking decisions on the basis of accurate and transparent information on the price and other aspects of the terms and conditions of a mortgage loan.[10]

A further aspect of product characteristics that is likely to exert an influence on the monetary policy transmission mechanism is the legal possibility to refinance, in particular, a fixed rate mortgage loan at a low cost for the borrower. In an environment where the cost of refinancing is low, borrowers may be induced to renegotiate their outstanding loans following a monetary policy easing, thereby reinforcing the

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[8] ECB, *The Monetary Policy of the ECB*, January 2004.

[9] Miles, D., "The UK Mortgage Market: Taking a Long-Term View", HM Treasury, 2003.

[10] In accordance with Article 285 of the Treaty, which sets out the legal framework for the production of statistics where necessary for the performance of the activities of the Community, the Eurosystem works on the harmonisation of definitions and improvements in rate comparability. In this context, it is noted that with respect to the Annual Percentage Rate (APR) the Eurosystem has a general interest, for statistical purposes, in the application of a consistent calculation method to the APR on mortgage loans and consumer credit. See also Regulation ECB/2001/18 concerning statistics on interest rates applied by monetary financial institutions to deposits and loans vis-à-vis households and non-financial corporations.

downward adjustment of mortgage lending rates. In contrast, this type of renegotiation would not be expected when interest rates are increasing. If refinancing is possible, a monetary policy easing is likely to increase households' disposable income in a fashion somewhat similar to the effect of variable rate mortgages. However, in this case the effects are asymmetric, depending on whether interest rates are rising or falling, and may also cluster around particular threshold levels.

The size of such effects would depend on the costs of refinancing, which are normally in the form of early repayment fees. The Green Paper highlights that the early repayment regimes vary widely across Member States. Indeed, while in some countries the early repayment fee compensates the lender for funding and operational losses arising from the early reimbursement of the loan, in other countries this fee does not exist or is capped. These differences in the cost of refinancing are mainly due to different preferences of Member States in consumer legislation. These differences have the potential to contribute to some heterogeneity in the transmission of interest rate changes in the euro area, although they are normally unlikely to be a major reason for differences.

When choosing to refinance an existing mortgage loan, households may also seek to increase their debt in order to raise funds for consumer expenditure. One method consists in withdrawing equity from housing through the mortgage market. Another method involves the granting by a lender of "top-up" finance that allows households with little or no outstanding debt to take further loan advances or a second mortgage loan on their existing property. While housing equity withdrawal through the mortgage market is generally not as widespread in the euro area as in certain other countries, it plays a potentially important role in linking developments in the housing market with consumer spending. Cross-country differences in the products offered by mortgage lenders to support mortgage equity withdrawal and in the related transaction costs are likely to introduce heterogeneity into the conditions faced by households to finance consumption. This, in turn, may eventually also affect domestic demand and price developments, thus making the transmission of monetary impulses less homogeneous.[11]

Overall, the Eurosystem needs to take into account any institutional features that potentially introduce heterogeneity into the monetary policy transmission mechanism. The Eurosystem is in favour of a further integration of financial markets. At the same time, changes in mortgage market characteristics – such as those discussed above – that affect the interplay between mortgage and housing markets and thus the amplitude and volatility of financial and housing cycles may have consequences which are difficult to predict. Thus, initiatives in this field, whether regulatory or market-led, need to be well designed and their possible implications for monetary policy assessed carefully.

3 Financial stability issues

From a financial stability viewpoint, mortgage market integration is relevant to the extent that further integration affects both the level of systemic risk and the channels for the transmission of shocks, as well as the behaviour of the different participants in housing finance activities.

[11] The statistical measurement of this phenomenon is currently under consideration by the Eurosystem.

The nature of systemic risk would differ depending on how risks are distributed among market players and/or between market players and consumers. Accordingly, whether an integration of mortgage markets results in fixed or floating rate mortgages being prevalent affects the overall stability of the system to the extent that awareness of and readiness to address risks are different across households and financial institutions.

A preponderance of floating rate mortgages - other things being equal - results in greater credit risk but lower interest rate risk for banks, as the risk of sharp interest rate adjustments is borne by those borrowing using floating rate instruments. Where fixed rate mortgages prevail, banks reduce the risk of borrowers' default by bearing the interest rate risk inherent in the instrument – a risk that can be passed on to capital market participants via long-term refinancing instruments.[12] Clearly, banks would need to adapt their risk management systems to a new environment in either case, as failure to do so would favour innovators at the expense of the laggards.

Furthermore, more closely integrated mortgage markets favourably allow a wider pooling of idiosyncratic risks (across regional boundaries with possibly distinct housing cycles) and a greater and more liquid source of finance, while at the same time could unfavourably create potential channels – through financing or credit risks – of wider contagion of formerly isolated risks. Likewise, the possibility of larger players in the market embodies both benefits (economies of scale and scope) as well as potential pitfalls (moral hazard issues associated with the notion of "too big to fail") and thus represents mixed possibilities on which no consensus view has yet emerged.

A key issue relates to the risks incurred by individual participants in housing finance activities, which are affected largely by the impact of integration on the competitive environment reigning in mortgage markets. On the one hand, to the extent that greater competitive intensity results in easier access to credit through a lowering of standards in credit risk assessment, a reduction of lending margins or greater exposure to housing markets where prices may be out of line with fundamental values, risks may rise. On the other hand, insofar as more competition improves the efficiency of the financial sector and fosters the development of better risk management efforts and techniques, risks may fall. It should be noted in this context that mortgages are - thanks to collateralisation - relatively secure financial products, and risk management practices are generally assessed as being sound.

Overall, the further integration of mortgage markets embodies risks and opportunities with regard to the stability of the euro area financial system as a whole. To the extent that the process of integration develops further, the monitoring activity carried out by central banks and supervisory authorities to safeguard financial stability will have to be reinforced by intensifying their cooperation and exchange of information on a cross-border basis.

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[12] Fixed rate mortgages – also by being conducive to long-term financial relationships – may contribute to financial stability.

4 Funding of mortgage credit: a financial integration perspective

A growing share of mortgage lending is funded on capital markets via the issuance of mortgage-covered bonds and mortgage-backed securities (MBSs).[13] The provisions laid down in the forthcoming Capital Requirements Directive[14] concerning covered bonds and MBSs are an important step to favor convergence across the EU. Nevertheless secondary markets, particularly in mortgage loans, remain fragmented due to differences in the legal, tax and regulatory frameworks that prevail in the various jurisdictions and the heterogeneity of the standards and practices adopted by market participants. Moreover, there are certain specific impediments to the cross-border origination and transfer of mortgage loans. As a consequence, secondary market liquidity, particularly in mortgage loans, remains low and economies of scale and cross-country diversification benefits have not yet been fully reaped. Some European markets in mortgage-backed instruments have reached successfully the stage of international funding of their domestic products, while the final stage of a funding instrument backed by a pan-European mortgage portfolio has not yet materialised.

Fostering the development of a pan-European funding market by facilitating the transfer of mortgage loan portfolios across borders could help to promote primary market integration. It would allow lenders to penetrate foreign markets with more ease since they would not have to build up the infrastructure to originate mortgage loans. This would increase competition among lenders.

The Eurosystem welcomes the Commission's approach of considering also mortgage funding instruments, and in particular covered bonds and MBSs, in its efforts to foster the integration of mortgage credit markets in the EU. It is noted that private sector initiatives could also play a prominent role in achieving further convergence of market practices on the funding side. Moreover, the Eurosystem wants to draw the Commission's attention to the fact that these instruments represent almost 30% of the assets that the Eurosystem's counterparties put forward as collateral in the framework of monetary policy operations.

Domestic and cross-border transferability of mortgage loans

Solving the problem of a more convenient transferability of mortgage loans – both at the domestic and cross-border levels - figures among the various measures needed to achieve the integration and development of the European markets for mortgage funding instruments. Unbureaucratic domestic and cross-border transferability of mortgage loans eases the creation and management of the loan portfolios which back the issuance of covered bonds and MBSs. As pointed out above, this enables issuers to diversify the underlying loan portfolios geographically and makes it easier to penetrate foreign lending markets. Moreover, it helps to reach the critical mass necessary in the underlying loan portfolios to issue covered bonds and MBSs.

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[13] According to the European Mortgage Federation and the European Securitisation Forum, as at end-2004 residential mortgage loans outstanding in the EU amounted to EUR 4,700 billion (9.7% higher than at the end of 2003). The outstanding amount of mortgage-covered bonds was EUR 779 billion (gross issuance in 2004 was EUR 240 billion) and that of residential mortgage-backed securities was approximately EUR 320 billion (gross issuance in 2004 of EUR 139 billion).

[14] Proposal for directives of the European Parliament and of the Council re-casting Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions and Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions (not yet published in the EU Official Journal). This proposal was approved by the ECOFIN Council on 11 October 2005.

The facilitation of the transfer of mortgage loans, even within a given jurisdiction, is crucial for the launch of any "true sale"[15] MBS programme, as it is necessary to pool assets within a common and transparent entity prior to issuing securities backed by these assets. It should be ensured that domestic regulatory frameworks facilitate such transferability and that any obstacle which might impede the transfer of mortgage loans be lifted at both the domestic and, where possible, the cross-border level.

The Eurosystem thus supports the Commission's view that a key aspect for the further integration of the EU primary and secondary markets in loan funding is the more convenient transferability of mortgage loans. On a related issue, in the context of the recent Eurosystem decision to include bank loans[16] in the Single List of Collateral for monetary policy operations, the Eurosystem recently expressed its support[17] for EU legislation harmonising the legal framework for taking bank loans as collateral for Eurosystem purposes, and for an easing of the formal requirements relating to the use of bank loans as collateral (including in relation to the transferability of such loans).

The Eurosystem notes that the Green Paper mentions some of the measures which could help to make transfers of mortgage loans easier. In particular, the Green Paper mentions as possible avenues to facilitate cross-border mortgage financing, the standardisation of mortgage contracts and the introduction of a Euromortgage under a so-called 26th regime. While the Eurosystem welcomes any initiatives that might facilitate the achievement of this objective, it would emphasize that such initiatives raise complex legal issues warranting a careful assessment as to their feasibility since they touch upon national property and contract law - areas that are firmly rooted in the national legal traditions of each Member State.

Integration and standardisation of secondary markets in the EU

The emergence of national legislation on covered bonds in various European jurisdictions and the introduction of securitisation frameworks, sometimes in a spirit of regulatory competition, have supported the growth of the overall size of the secondary markets and often enhanced the quality of the instruments. However, the ECB has expressed in recent opinions on draft national laws on securitisation[18] the view that securitisation is an area where considerable progress in integrating European financial markets could still be made, notably in terms of the convergence of market practices, instruments and legal rules.[19] The report on the costs and benefits of integration of EU mortgage markets requested by the Commission[20] suggests, along the lines of the Forum Group Recommendations (Nos 45 and 46), promoting legislation

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[15] i.e. where there is a legal transfer of underlying mortgage loans to a special-purpose vehicle.

[16] In the context of the collateral framework for monetary policy operations, a bank loan is defined as a debt obligation of an eligible debtor (a non-financial corporation or general government) to Eurosystem counterparties; see the ECB press release of 22 July 2005 entitled "Eurosystem collateral framework: Inclusion of non-marketable assets in the Single List".

[17] See footnote 7 (on page 8 of the referred Eurosystem contribution).

[18] See in this respect the ECB Opinion of 14 September 2004 at the request of the French Ministry of Economic Affairs, Finance and Industry on a draft decree concerning *fonds communs de créances* (securitisation funds) (CON/2004/30) and the ECB Opinion of 4 February 2004 at the request of the Ministry of Finance of the Grand Duchy of Luxembourg on a draft law on securitisation (CON/2004/3).

[19] It is noted in this respect that the European Financial Markets Lawyers Group is currently examining possible recommendations for further integration of securitisation legal frameworks in Europe (www.efmlg.org).

[20] See London Economics, "The Costs and Benefits of Integration of EU Mortgage Markets", report for the European Commission (DG Internal Market and Services), August 2005.

that creates certainty with regard to the segregation of assets and the legal recognition of the bankruptcy remoteness of special-purpose vehicles.

As a complement to public action, industry associations and fora can be very effective in ensuring the convergence of trading standards such as issuance practices and market-making arrangements. Further standardisation in these areas would foster market transparency and liquidity, thus improving market functioning and enhancing markets' attractiveness to investors.

5 Conclusions

The Eurosystem welcomes the European Commission's initiative to issue a Green Paper on Mortgage Credit in the EU. With its public consultation, the Commission is launching a broad discussion about the possible benefits and ways of further integrating European mortgage markets. As financial integration is generally lagging behind in retail financial markets in Europe, the Eurosystem is of the view that such an investigation of possible benefits of and obstacles to the further integration of European mortgage markets is very much warranted.

The Eurosystem has a keen interest in fostering European financial integration, as financial integration is relevant for the transmission and implementation of monetary policy, as well as for the safeguarding of financial stability. The Eurosystem sees financial integration first and foremost as a market-driven process. While the contribution of public authorities is to create a framework conducive to fostering financial integration, the Eurosystem attaches significant importance to the role of market participants, in particular through the promotion of convergence in market practices. At the same time, changes in mortgage market characteristics that affect the amplitude and volatility of financial and housing cycles may have consequences which are difficult to predict and may potentially lead to financial crises. Thus, initiatives in this field, whether regulatory or market-led, need to be well designed and their possible implications for monetary policy and wider macroeconomic stability assessed carefully. Central banks, as well as banking supervisors, in their fields of competence, should also be closely associated to any initiatives in order to assess the potential impact on prices and financial stability. It is against this background that the Eurosystem has submitted this contribution to the Commission's public consultation.