



European Banking Industry Committee

European Banking Federation (EBF) • European Savings Banks Group (ESBG) • European Association of Cooperative Banks (EACB) European Mortgage Federation (EMF) • European Federation of Building Societies (EFBS)
European Federation of Finance House Associations (Eurofinas)/European Federation of Leasing Company Associations (Leaseurope)
European Association of Public Banks (EAPB)

Mr Svein Andresen,
Secretary General
Secretariat to the Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland.

25 October 2010

Dear Mr Andresen,

On behalf of the EBIC Chairman, Mr Gerhard Hofmann and the Chairman of the EBIC Working Group on Mortgage Credit, Mr Michael Coogan, please find attached the EBIC Response to the FSB Review of residential mortgage underwriting and origination practices.

We hope that these comments will add benefit to your Review and that they will explain the particular situation of the European mortgage market. Should you have any queries please do not hesitate to contact us.

Yours Sincerely

A handwritten signature in black ink, appearing to read 'G. Hofmann'.

Gerhard Hofmann
EBIC Chairman

A handwritten signature in black ink, appearing to read 'M. Coogan'.

Michael Coogan
Chairman of Working Group on Mortgage Credit

EBIC Response to Financial Stability Board Review of Residential Mortgage Underwriting and Origination Practices

▪ Introduction

EBIC welcomes the opportunity to comment on the Financial Stability Board's (FSB) Review of Residential Mortgage Underwriting and Origination Practices which is based on the recommendations made by the Joint Forum in its January 2010 Review of the Differentiated Nature and Scope of Financial Regulation.

The EU Banking Industry has been and continues to be willing to take stock of the difficulties created by the economic crisis and to respond actively to the ensuing general need for increased transparency and confidence, notably in the field of responsible lending. In this respect, EBIC would like to take this opportunity to stress that it attributes primary importance to consistent and effective underwriting practices in residential mortgage origination, which underpin, and are therefore fundamental to, mortgage lending systems.

However, EBIC notes the findings highlighted in the Joint Forum Review that there has been poor residential mortgage underwriting practices and inconsistent supervisory and regulatory regimes for similar activities and products present in the global financial market. In the first instance, EBIC would like to stress that a clear distinction should be made between the way in which the crisis unfolded in the US and the knock-on effects that this has had in the EU.

▪ Difference between US and EU Mortgage Markets

As the FSB will be aware, the global financial crisis was triggered in the US by a combination of two elements: on the one hand, the almost exclusive reliance in the US on the 'originate to distribute' model, according to which loans were extended, packaged and sold on in the market, meaning that the risk associated with the loan did not remain with the lender, and as DG ECFIN explains in its 2009 Publication "*Economic Crisis in Europe: Causes, Consequences and Responses*", "the creditworthiness of the borrowers was no longer assessed by the originator of the loan"¹. On the other hand, as a consequence of the model described above, irresponsible lending to subprime borrowers proliferated, and was fuelled by abundant liquidity and rising housing prices.

This combination of factors should be seen against a backdrop of extreme pressure from the US government to expand home ownership, particularly to low income households. The political pressure to expand homeownership led Government Sponsored Enterprises, Fannie Mae and Freddie Mac, which had been established to this very end after the Great Depression of the 1930s, to relax their credit requirements, opening the door to the issuance of increasingly riskier mortgages, which were in turn pooled into riskier mortgage backed securities (MBS). This practice ultimately led to the near collapse of Fannie Mae and Freddie Mac in 2007/2008

¹ Page 13.

after the onset of the subprime crisis, when borrowers began to default on their questionable loans.

The widespread disregard of responsible lending and borrowing in the US had disastrous effects on the entire global economy. In the EU, the direct knock-on effect was a liquidity and confidence crisis, as a result of many EU banks having invested in US securitisation portfolios containing subprime toxic loans on the basis of erroneous credit rating agency ratings and as a consequence of inadequate internal risk management and supervision on the investment side by supervisory authorities. This resulted in a general questioning of the banking sector as a whole and a parallel collapse in confidence. In turn, this led to a severe drying up of liquidity and a subsequent "credit crunch" in a number of Member States.

Against this background, it is extremely important to underline that, unlike in the US, the crisis in the EU has not been a mortgage market crisis, and certainly not a dysfunction of European mortgage markets driven by irresponsible mortgage underwriting and origination practices. In the EU, responsible practice and legal incentives have to this end been in force for several years and include the following:

- As opposed to the US reliance on the 'originate to distribute' model, in the EU lenders resort to a mix of funding techniques including savings deposits (~53%), covered bonds (~23%) and securitisation (~16%), which means that a minimum of 75% of the loans - and corresponding risks- remain on the lender's balance sheet.

Additionally, it is important to note that securitisation in the EU was not comparable to the US as almost all lenders in the EU that have used securitisation have retained an ongoing economic interest in the loans through a retained first loss position or seller share whilst in the US it was normal for lenders to sell all tranches including the first loss tranche to investors. It should also be recalled that rules surrounding securitisation will be further strengthened in the EU with the new Article 122a of Directive 2009/111/EC, which will promote sound risk management by investors, sponsors, originators and underwriters. In this respect, we would like to take this opportunity to indicate that EBiC believes that securitisation is important for well-functioning efficient, strong and stable financial markets, and is therefore committed to strengthening the framework for underwriters as well as investors in securitisation markets.

- The fact that it is longstanding EU-wide practice for lenders to grant or refuse loans based on their assessment of the prospective borrower's capacity to repay their loan on their income, and not based on the lender's ability to enforce the collateral;
- In the context of the 2008 Review of the Capital Requirements Directive (2006/48/EC), an amendment to the Directive ensures that an institution issuing a bond/investment exposure retains a material interest in the performance of the proposed bond/investment exposure. The retention rate was fixed at 5% of the total value of the securitised exposure.

- As quoted on page 6 of the European Commission's Note on the ECOFIN Roadmap on Financial Turmoil of September 2008, practice at EU retail level shows that instances of mis-selling are "few and far between".

As a result, even with rising unemployment, the functioning of EU mortgage markets remains satisfactory in most Member States with a limited progression of arrears and repossession.

Although it is acknowledged that there have been some cases of irresponsible lending in the EU, the Industry must emphasise that such cases have been observed in a small number of Member States, where they have been limited to the fringes of the mortgage lending industry, and did not reach the level of subprime loans as in the US market. It is our view that such lending practices were not compatible with existing regulatory requirements and resulted from a small number of lenders failing to properly apply affordability requirements and from regulators failing to properly enforce these requirements. The relevant national authorities in the Member States in question are currently in the process of addressing these failings through a programme of enhanced supervision, which is arguably the most appropriate and efficient level, where national regulators are able to tailor their responses to the specificities of their own particular market.

With these considerations in mind, the Industry firmly believes that in the first instance, global and European policymakers should not be looking to apply solutions in the EU, which respond to problems identified in the US, and would like to stress as outlined above that where failings have been identified in a very small number of EU Member States, these should be, and are being, dealt with at the national level.

EBiC would like to turn now to the specific points on which the FSB has requested feedback for the purposes of its Review:

- **Gaps in regulatory and supervisory oversight**

EBiC would like to emphasise that mortgage lending provided by banks across the EU is far from unregulated. In addition to existing consumer protection legislation at Member State-level specific to the assessment of consumer creditworthiness, under existing national supervisory regimes, granting a loan without carrying out a creditworthiness assessment would constitute an infringement of supervision rules. This information should be forthcoming from the questionnaires that have been circulated to the EU Member States' public authorities by the FSB. As such, checking a prospective borrower's creditworthiness before granting him a loan is a normal, mandatory prerequisite for EU mortgage lenders, although their assessment criteria vary depending on the individual policies of the Member State and credit institution.

EBiC believes that this issue should remain within the scope of banking supervision rules, and would like to underline that it is also already adequately regulated by Directive 2006/48/EC (Capital Requirements Directive, implementing the Basel Agreement, Basel II). Indeed, the obligation to assess creditworthiness is set forth by the CRD, for purposes pertaining to the provision of risk capital. It is worth emphasising that ultimately the lack of an adequate creditworthiness assessment would increase the risk of borrower default, potentially resulting in foreclosure procedures, which would not be in the commercial interest of the lender.

Furthermore, there are also a number of national codes of conduct in application across the Member States both regarding mortgage and consumer credit, which are monitored by the respective National Supervisory Authorities across the Member States. These authorities are also in charge of the implementation and monitoring of guidelines for fair business practices, including practices contained in national self-regulatory codes.

As indicated earlier however, one area where supervisory oversight did fail was in the monitoring of banks' investment activities by national supervisory authorities. A lack of adequate supervision ultimately contributed to creating an environment, in which EU lenders were able to invest in US securitisation portfolios containing toxic subprime loans. It was this investment activity which triggered the liquidity and confidence crisis in the EU and resulted in a widespread credit crunch.

- **Areas where regulations or guidance from different agencies might overlap;**

It is the view of EBIC that there is potentially a multilayered process of regulation taking place at international level, EU level and national level, adding to the legislation and national codes of conduct already in application across EU Member States and monitored by the respective supervisory authorities in the area of lending, which needs to take into consideration the economic ability of banks to process this multifaceted regulation. Further European legislation is envisaged by the European Commission in the form of a proposal for a Directive on Responsible Mortgage Lending and Borrowing legislation, which is likely to be announced in early 2011. The Directive will include provisions on creditworthiness assessment. In parallel, and as outlined above, many national authorities are also carrying out reviews of their own mortgage markets in response to the economic crisis.

The cost implications to lenders of implementing new national regulations which could be subsequently superseded by EU level and then possibly International level regulation cannot be borne unless it is co-ordinated and consistent; there is a real need for joined up thinking if this type of regulation/regulatory environment is envisaged and more fundamentally if it is to work.

- **Current or best practices for measuring a borrower's ability and willingness to repay;**

As emphasised earlier in this Response, it is standard practice in the EU to carry out creditworthiness assessments on potential borrowers prior to the granting mortgage loans in the EU.

In particular in response to recommendation 7 of the Joint Forum Review, it should be pointed out that under existing national supervisory regimes imposed by European regulation/legislation, (Directive 2006/48/EC (Capital Requirements Directive, implementing the Basel Agreement, Basel II) granting a loan without carrying out a creditworthiness assessment would constitute an infringement of banking supervisory rules.

As indicated earlier, the Industry firmly believes that the supervisory level is the most appropriate level at which the obligation to assess creditworthiness should be developed, as necessary. Imposing on EU lenders detailed civil law obligations relating to the assessment of the borrowers' creditworthiness would not only be unjustified given the low levels of defaults shown at EU level in the mortgage market, but which would also impact adversely on contractual obligations between lenders and consumers, and would create a complaint and regulatory risk for a lender in the event of default. If new legal or regulatory risks are introduced which cannot be managed, lenders' response in the EU will be to considerably restrict lending. This runs contrary to the desire at EU level that lenders continue to lend, and even lend more, to aid the EU's recovery from the crisis.

- **Challenges faced by underwriters or originators that operate in several countries.**

Experience across EU Member States suggests that generally consumers do not cross borders to access mortgage credit. Where they do it is for specific reasons such as to purchase a holiday home and by and large demand for cross border mortgages is low.

Where lenders engage in cross border lending they do so through subsidiaries that operate under the national rules of the Member State in which they are located.

This being said, one of the key challenges to mortgage lenders wishing to lend on a cross-border basis relates to access to credit registers. The diversity of existing national databases i.e. the fact that there are positive and negative, private and public and centralised and non-centralised databases, means that lenders are often faced with difficulties in accessing information they require in order to assess the creditworthiness of potential borrowers and therefore to take a decision on a credit request by a consumer.