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COMMISSION STAFF WORKING PAPER
SUMMARY OF THE IMPACT ASSESSMENT

Accompanying document to the

Proposal for a
DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL
on credit agreements relating to residential property

(Text with EEA relevance)

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1. INTRODUCTION

Responsible lending is defined as the care taken by creditors and intermediaries to lend amounts that consumers can afford and meet their needs and circumstances. Similarly, responsible borrowing implies that consumers should provide relevant, complete and accurate information on their financial situation, and are encouraged to make informed and sustainable decisions.

2. PROBLEM DEFINITION

2.1. Problems

Rising household debt levels exist throughout Europe. However, they are not in themselves a sign of irresponsible lending and borrowing as long as the levels of debt are sustainable and repayments can be met. Figures show though that citizens are having increasing difficulties in meeting their debts: in 2008, 16 % of people reported difficulties in paying bills and 10 % of all households reported arrears¹. The difficulty in meeting repayments has led to an increase in default rates and a rise in foreclosures.² Data can be influenced by factors other than irresponsible lending and borrowing such as the general economic downturn. However, the data collected for this impact assessment, combined with qualitative evidence through stakeholders' contributions, and anecdotal evidence from across Europe shows that this is not just a conjunctural problem limited to one or two Member States but can be found throughout the EU.

A range of factors drive the decision to grant a particular mortgage credit, the borrower's eventual choice of mortgage product and the borrower's ability to repay the loan. These include the economic climate, information asymmetries and conflicts of interest, regulatory gaps and inconsistencies, as well as other factors such as a borrowers' financial literacy and mortgage financing structures. While these other factors clearly play a role, the fact remains that irresponsible behaviour by certain market actors was at the source of the financial crisis. It is therefore clear that irresponsible lending and borrowing needs to be addressed to avoid a repeat of the current financial crisis.

The following problems were identified in relation to irresponsible mortgage lending and borrowing practices. In addition, to the problems described below, several problems were identified relating to the early repayment of mortgage loans. These problems, which create an unlevel playing field, inhibit cross-border activity and customer mobility and impact on consumer confidence, are described in detail in the impact assessment accompanying the *White Paper on the Integration of EU Mortgage Loans*.³

¹ *Europeans' state of mind*, Eurobarometer 69, November 2008. *Towards a Common Operational European Definition of Over-indebtedness*, Observatoire de l'épargne Européenne in cooperation with CEPS and the University of Bristol, February 2008.

² Information provided to the Commission by Member States.

³ SEC(2007) 1683.

2.1.1. Non-comparable, unbalanced, incomplete and unclear advertising and marketing

Cases of inappropriate advertising of mortgage products can be found throughout the EU. Incomplete and unclear advertising and marketing material is often difficult to compare and does not allow consumers to shop around. Despite national legislation and EU rules forbidding misleading advertising, inconsistencies and gaps exist. Different rules also mean that those creditors and/or credit intermediaries offering products and services cross-border will face an additional burden.

2.1.2. Insufficient, untimely, complex, non-comparable and unclear pre-contractual information

Efforts have been made to improve the quality and comparability of pre-contractual information, e.g. the European Code of Conduct on pre-contractual information for home loans. However, application of the Code has been mixed, and enforcement and monitoring mechanisms ineffective. The timing of the provision of the agreed European Standardised Information Sheet (ESIS) varies, limiting its use, for example, to compare offers. Despite the existence of the Code, a series of market failures persist. First, pre-contractual information is difficult to compare. Different methodologies and cost bases also make a key element of the ESIS, the Annual Percentage Rate of Charge (APRC), incomparable. Second, consumers view the information provided as complex and unclear. Third, the information provided is often incomplete. Finally, there are no rules in place governing the disclosure of information on the relationship between the creditor and credit intermediary.

2.1.3. Provision of inappropriate advice

Misaligned incentives in the provision of advice can lead to market failures. Advisors may face disincentives to provide impartial advice, e.g. because they receive different levels of remuneration from different creditors for the sale of specific products. Evidence shows that inappropriate mortgage advice has been given in a number of instances, leading to consumer detriment. In the absence of rules or standards against which the provision of advice can be assessed, it is difficult to determine whether the advice given was appropriate.

2.1.4. Inadequate suitability and creditworthiness assessment

An important market failure in this area is the lack of incentives to undertake thorough creditworthiness and/or suitability assessments. Creditors may rely on the value of the underlying collateral (mortgaged property), transfer the risk of default or sell the loan to a third party. Similarly, consumers may also have an incentive to overstate their income in order to obtain the loan. Regulatory failures in the form of inexistent, unclear or inconsistent regulatory frameworks further contribute to inadequate suitability and creditworthiness assessments. Regulatory barriers also inhibit the ability of creditors to access information on a borrower's creditworthiness cross-border via a credit database.

2.1.5. Ineffective, inconsistent or non-existent registration, authorisation and supervision regimes for credit intermediaries and non-credit institutions providing mortgage credit (NCIs)

Not all Member States require credit intermediaries to be registered or authorised, which may create the potential for irresponsible behaviour. The lack of registration or authorisation requirements also means that authorities have little scope for supervision of credit

intermediaries' activities or imposing sanctions for misconduct. This has the potential to create an uncompetitive environment in which misconduct, excessive risk taking or poor advice is not held to account. Cross-border activity of credit intermediaries is extremely limited at present: the regulatory patchwork prevalent at EU level can inhibit a business's decision whether to engage in cross-border business.

Six Member States have no registration and authorisation requirements for NCIs, and requirements vary widely between the other Member States with regulation in place. The lack of registration or authorisation requirements means that authorities have little basis for the supervision of NCIs' activities or for requiring sanctions for misconduct, with similar effects to those described above.

2.2. Consequences

The problems identified result in consequences for consumers, credit intermediaries, creditors and the economy at large.

2.2.1. Significant spill-over effects on the wider economy

Mortgage credit markets play an important role in the EU economy. In 2008, outstanding residential mortgage lending in the EU27 represented about 50 % of EU GDP. Therefore, irresponsible lending and borrowing can have a significant effect on the wider economy. It affects the solvability of mortgage lenders. As financial institutions need to put aside increasing amounts of capital to cover bad losses, the availability of credit for responsible borrowers and companies is reduced, which in turn places limits on economic growth and consumption. Irresponsible lending and borrowing also has a financial impact through government bail-out programmes or nationalisation, and as a consequence, government budgets are put under strain and budget cuts are often necessary. Finally, social safety nets are put under strain with rising unemployment and increased demand for social expenditure and housing.

2.2.2. Risk of consumer detriment

Consumers who are sold unsuitable products often run into financial difficulties, leading to overindebtedness, as well as default or foreclosure. Consumers may be damaged by regulatory barriers that prevent creditors properly assessing creditworthiness and suitability or the additional costs faced by creditors operating on a cross-border business. Such consumers could face a direct financial detriment (e.g. paying a higher price for a product that could be available for less) or a potential social detriment (e.g. not obtaining a mortgage credit despite being able to repay). Finally, consumers may also lose confidence in creditors and credit intermediaries.

2.2.3. Low customer mobility

Several of the problems identified above impede customer mobility. A lack of transparency and comparability can lead to consumers failing to shop around for the best offer for their needs. Consumers seeking to take out a loan in a country other than their country of origin may face higher prices or be denied the opportunity due to the fact that the foreign creditors are unable to access sufficient information on the consumer's credit history.

2.2.4. *Low cross-border activity*

Economic barriers such as the costs of accessing infrastructures and the need to adapt advertising material, information disclosures, products, business models and pricing strategies raise the costs of doing business in another Member State. These barriers deter market entrants and limit competition. For example, credit intermediaries seeking to operate cross-border face an additional burden: unlike investment or insurance intermediaries, there is no 'passporting' regime.

2.2.5. *Unlevel playing field between market actors and products*

The regulatory gaps and inconsistencies in the regulatory frameworks have created a situation where mortgage market actors engage in the same activities, face similar risks but do not necessarily face similar rules. The different regulatory frameworks on consumer credit and mortgage credit can also lead to arbitrage between the two different loan products (consumer credit and mortgage credit).

3. POLICY OBJECTIVES

There are two general objectives that are common to all problem areas. First, to create an efficient and competitive Single Market for consumers, creditors and credit intermediaries with a high level of consumer protection by fostering the following four specific objectives:

- consumer confidence;
- customer mobility;
- cross-border activity of creditors and credit intermediaries;
- a level playing field.

Second, to promote financial stability by ensuring that mortgage credit markets operate in a responsible manner.

4. THE CASE FOR EU ACTION

Action from Member States alone will result in different sets of rules, which may undermine or create new obstacles to the functioning of the internal market and create unequal levels of consumer protection throughout the EU. Common standards at EU level are therefore necessary to promote an efficient and competitive internal market with a high level of consumer protection and to avoid the development of divergent rules and practices in the Member States. The Treaty provides for action to ensure the establishment and functioning of an internal market with a high level of consumer protection as well as the free provision of services. Such a market for residential mortgages is far from completion as several obstacles exist to the free provision of services and the creation of an internal market. The legal basis for action is in the following Treaty provisions: Article 114 (ex-Article 95).

5. POLICY OPTIONS

A number of policy options have been identified. The table below summarises these options. The retained options are highlighted. The analysis has proven that those options are the most effective and efficient in achieving the objectives described above. The policy options for early repayment are analysed and assessed in detail in the impact assessment accompanying the *White Paper on the Integration of EU Mortgage Loans*⁴ and the study assessing the costs and benefits of different policy options for mortgage credit⁵.

Advertising and marketing
1: Do nothing
2: Introduction of advertising rules similar to those contained in Article 4 of the Consumer Credit Directive (CCD)
3: Introduction of specific rules on the form and content of advertising and marketing materials
Pre-contractual information
1: Do nothing
2: Ensure that consumers receive the ESIS
3: Ensure that the ESIS is provided in sufficient time to enable consumers to shop around
3.1: Principles-based requirement
3.2: Specify a deadline for the provision of information
4: Improve the format and content of the ESIS
5: Standardise the APRC
5.1: Standardise on the basis of a narrow list of costs
5.2: Standardise on the basis of Article 19 of the CCD
5.3: Standardise on the basis of a broad list of costs
6: Additional pre-contractual information on the actor who offers the mortgage (e.g. remuneration)
Mortgage advice
1: Do nothing
1.2: Requirement to provide adequate explanations (Article 5(6) of CCD)
1.3: Principles-based advice standards
1.4: Requirement to provide mortgage advice
Remuneration strategies of advisors
2.1: Do nothing
2.2: Principles-based guidance on remuneration policies
2.3: Specific rules on methods and levels of remuneration
Creditworthiness assessments
1.1: Do nothing
1.2: Requirement for the creditor to assess the borrower's creditworthiness
1.3: Requirement for the creditor to deny the credit in the case of negative creditworthiness assessment
1.4: Non-discriminatory access to databases for creditors
1.5: Homogenise the content and characteristics of data bases
1.6: Requirement for the borrower to provide correct information on his/her situation
Suitability assessments
2.1: Do nothing
2.2: Requirement for the creditor or the credit intermediary to assess the suitability of the product offered
2.3: Requirement to warn the borrower if the chosen credit product is not suitable to him/her
2.4: Requirement for the borrower to provide correct information on his/her situation
2.5: Specific product regulation including bans or caps on certain credit products
Credit intermediaries: Registration and authorisation
1.1: Do nothing
1.2: Principles-based requirements
1.3: Specific requirements
1.4: Introduce a passport

⁴ SEC(2007) 1683.

⁵ *Study on the costs and benefits of different policy options for mortgage credit*, London Economics with Achim Dübeler (Finpolconsult) in association with the institute für finanzdienstleistungen (iff), November 2009, p. 200-336.

Credit intermediaries: Prudential requirements and supervision
3.1: Do nothing
3.2: Principles-based requirements
3.3: Specific requirements
3.4: Introduce EU level supervision
NCIs: Registration and authorisation
1.1: Do nothing
1.2: Principles-based requirements
1.3: Specific requirements
NCIs: Prudential requirements and supervision
3.1: Do nothing
3.2: Principles-based requirements
3.3: Specific requirements
3.4: Introduce EU level supervision

6. IMPACTS

The preferred options will reduce the likelihood of consumers purchasing an unsuitable mortgage credit product. A strong positive effect on consumer confidence is also expected to underpin the demand for credit products and encourage consumer mobility both at national and, albeit to a lesser extent, cross-border level.

The implementation of some of the retained options will not lead to significant changes to the operation of market actors on the supply side in a number of Member States, where similar obligations already exist. However, the preferred policy options will have an important impact on the cross-border activity of creditors and credit intermediaries. The entry of foreign credit providers and credit intermediaries should strengthen competition and, thus, translate in a wider range of credit products for the consumer and potentially even a decrease in prices.

The global impact of this package cannot be calculated as a simple sum of individual impacts. This is due not only to the risk of double counting overlapping costs and benefits, but also because of the synergies between some options that should amplify their impact. According to Commission calculations based on current evidence, EUR 1 272–1 931 million appears as a conservative estimate for the range of expected benefits. Expected total one-off and ongoing costs are in the range of EUR 383–621 million and of EUR 268–330 million respectively.

Most of the preferred options' impacts will be spread all across the EU. However, for some of these options, the benefits and costs will be amplified in those Member States which will need to substantially adapt the rules in place or introduce a complete regulatory framework (e.g. in those countries where credit intermediaries or NCIs are not regulated at all).

Two opposite potential social impacts can be identified: there is a risk that responsible lending practices may result in reduced access to credit, particularly for certain groups of borrowers (e.g. with a low income), however, responsible lending policies also enhance the sustainability of lending practices and thus social cohesion.

For most of the retained options no increase of the administrative burden is expected. The exceptions relate to the regulatory framework for credit intermediaries and NCIs where the costs linked to the authorisation and registration of these market actors, as well as to their ongoing compliance with the new legislation, will imply an administrative burden on those players.

7. CONCLUSION

The preferred policy instrument would be an EU Directive. A Directive enables proportionality to be taken into account through the level of harmonisation. Detailed harmonisation is not always necessary or appropriate in all instances: the structure of housing markets and mortgage markets differs considerably throughout the EU, the products and remuneration structures also vary considerably. EU intervention needs to be detailed enough to be effective but high level enough to be able to take into account Europe's diversity.

The proposed EU Directive would foresee a review of its appropriateness and effectiveness. This review should take place a few years after its implementation and include a public consultation.