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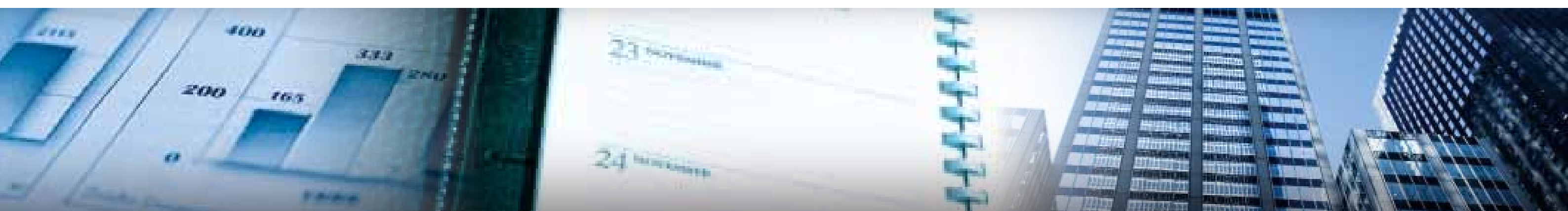

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# Hypostat 2011: outstanding lending continued to grow, but gross lending decreased significantly

By Sylvain Bouyon, Economic Adviser, European Mortgage Federation

On the 15th of November, the EMF published Hypostat 2011, which is the Federation's main statistical study encompassing data on recent developments in housing and mortgage markets in Europe and beyond. Hypostat is the result of a collaborative effort by the European Mortgage Federation's national delegations and external experts.

The publication covers 33 countries – i.e. the EU27, Iceland, Norway, Russia, Turkey, Ukraine and, for the fourth consecutive year, the United States of America, not only a key mortgage market but also the source of the subprime loans crisis that triggered the global credit crisis from Q3 2008.

As regards the key facts revealed by the latest Hypostat, in 2011, the euro area aggregate mortgage market recorded a 2% nominal increase on the previous year, thus slowing down after the robust growth experienced in 2010 (3.8%). This slowdown is partly explained by the 2011 contributions of the Portuguese and Spanish mortgage markets to the euro area's growth, which were negative for the first time in more than a decade. On the other hand, in line with 2010, the contribution of the French mortgage market to the euro area's growth was above 1%. In 2011, the UK mortgage market continued to grow at a very slow pace in domestic currency, at 0.5% (against 0.3% in 2010 and 0.8% in 2009). As regards the other non-euro

area EU27 economies, where the main objective of most central banks is to keep the value of the domestic currency stable with respect to the euro, the growth in euros was still significantly above the UK and the euro area.

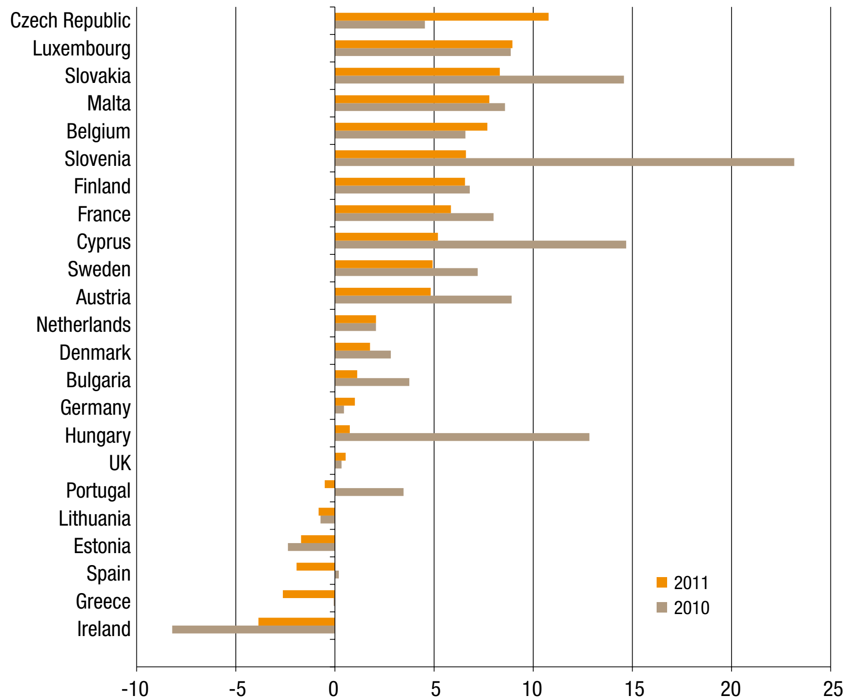
Regarding gross lending, the picture is much gloomier. Among the EU27 countries for which data is available, only Belgium and Germany registered a cumulative growth between 2007 and 2011. Most of the other EU countries recorded marked declines in that period. In 2011, the escalation of the euro area sovereign debt crisis led to a higher cost of funding for banks and an increase in the risk perception of banks, which, via the channel of lending standards, negatively affected gross lending. In a context of weak macroeconomic performance, high unemployment and a rapid deterioration in consumer confidence, the demand for new loans shrank abruptly after a noticeable recovery in 2010 and, as a consequence, further depressed gross mortgage lending. As a result, after a robust recovery in 2010, gross lending in the euro area contracted by more than 9% in 2011[1].

The decline in construction eased somewhat. After a deep contraction between 2007 and 2009, the number of building permits and housing starts increased moderately in 2010 and 2011 in the EU27. As regards housing completions, national data for 2011 generally did not reflect some of the developments recorded in building permits and/or housing starts, as completions typically respond belatedly - with at least a one-year lag - to upswings in residential construction activity. Thus, the number of housing completions in 2011 decreased noticeably in the EU27 and is expected to stagnate in 2012, partially reflecting the fluctuations in the volume of building permits and housing starts observed in the two previous years.

House prices continued to diverge across the EU27. After decreasing in 2009 in all EU27 Member States except Austria, Belgium, Portugal and Sweden, nominal house prices developed in a heterogeneous manner across EU countries in 2010. This mixed picture was confirmed in 2011. The significant drops recorded in house prices in several housing markets led to better housing affordability on these markets. However, in 2011, decreasing or stagnating house prices negatively affected housing market prospects and, via the channels of lending standards and the demand for loans, further depressed gross lending. In addition, as housing remains a major component of the wealth of households and SMEs, decreasing or stagnating housing house prices dampened both private consumption and private investment and, consequently, real GDP.

By end-2010, rising inflationary tensions, as a result of a new, significant increase in energy and food prices, and the noticeable depreciation of the effective

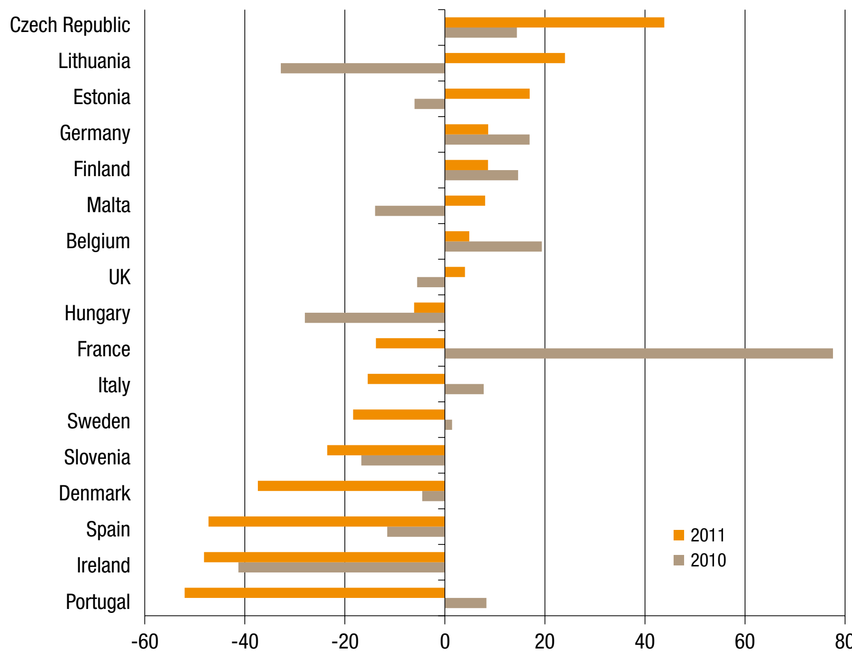
**Chart 1: Outstanding Residential Loans, Nominal Growth Rates, 2011 and 2010, %**




Source: European Mortgage Federation

Please note that these figures are calculated on values expressed in national currencies

**Chart 2: Gross Residential Loans, Nominal Growth Rates, 2011 and 2010, %**




Source: European Mortgage Federation

Please note that these figures are calculated on values expressed in national currencies

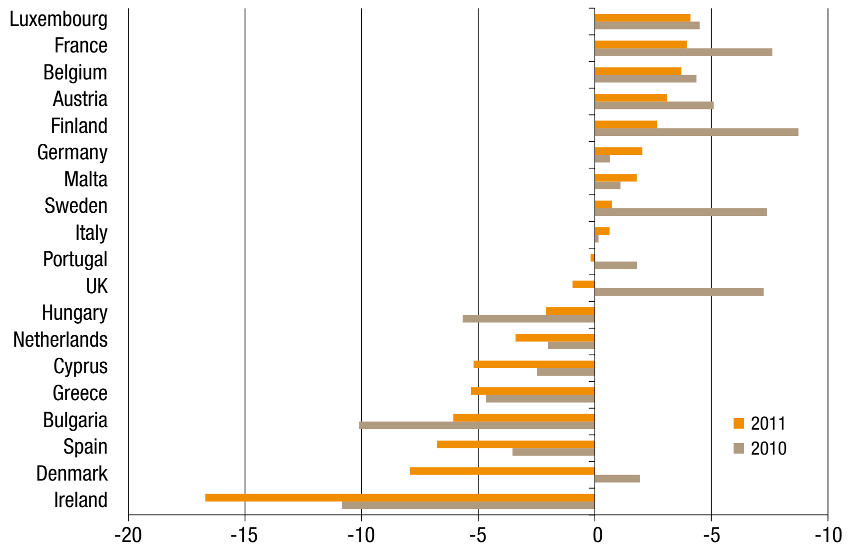
1 The sample related to gross lending in the euro area includes Belgium, France, Germany, Ireland, Italy, Portugal and Spain (i.e. around 86% of the euro area's GDP at current prices). This data is provided by the Quarterly Review Statistics of the European Mortgage Federation.

exchange rate of the euro, prompted the European Central Bank (ECB) and several other central banks to increase their policy rates in Q2 2011 and Q3 2011. Nevertheless, in Q4 2011, the anticipated easing in consumer-price inflation for 2012 and the sharp deterioration of the economic situation, resulting from the worsening sovereign-debt crisis in several Member States, led to an abrupt reversal in the ECB monetary policy. The ECB lowered its main refinancing rate by 50 bps, with two consecutive cuts between November and December 2011, taking it back to 1.00%.

In 2010 and 2011, tensions in European wholesale financial markets and specific economic situations led to divergent paths in mortgage interest rates among the Member States. While representative interest rates on new mortgage rates significantly increased during this period in Cyprus, Greece, Hungary, Ireland, Italy, Portugal and Spain, they decreased in Austria, Belgium, France, Germany, Poland and the UK.

Hypostat 2011 is available to download via the EMF website by clicking here.

**Chart 3: Nominal House Price's Growth Rates in 2010 and 2011, %**




Source: European Mortgage Federation

# New Exceptional Measures for Vulnerable Mortgage Debtors in Spain

By Lorena Mullor Gómez, Manager, Spanish Mortgage Association

On the 15th of November, the new *Royal Decree Law 27/2012 on urgent measures to reinforce the protection of mortgage debtors* was published, which includes exceptional measures - therefore limited in time - to address the most serious cases that are occurring in the *retail* mortgage market as a result of the severe crisis currently affecting Spain.

In particular, this legislation introduces two major measures:

Firstly, the **immediate cessation of evictions for a period of two years** for all households in a situation of special vulnerability and at risk of social exclusion. To measure the "vulnerability" of the debtor, the Royal Decree Law (RDL) considers both economic criteria - based on a limitation of earned income, a high LTI ratio and the alteration of the creditworthiness over the last four years - and household composition (families with children under three years, large families, single parents with dependent children or unemployed, etc.). For this group, upon certification of the current status, the credit institution waives its right to execute the eviction of the household, with the latter remaining in the home for a period of two years without any cost or charges, provided that whatever the foreclosure procedure implemented is (judicial or extrajudicial), it is the creditor - or someone acting on his behalf – that is awarded the property.

And secondly, the RDL gives a mandate to the Government to undertake measures that, together with the collaboration of the financial sector, aim at the creation of a **social fund for housing** for those households which, having been evicted from their home, can certify their compliance with the requirements provided for the vulnerable group defined in the RDL.

This new regulation responds to a widespread demand from many social groups which in recent months have been urging reform of the mortgage market laws to address the most delicate economic situations faced by mortgage debtors. That is why the Government, in addition to publishing this new legislation that proposes a *short-term* solution to the problems of the most vulnerable mortgage debtors in need of special and specific attention, has announced the need to undertake a legal reform - more calmly - of other more general matters such as the treatment of over-indebted households or the analysis of possible improvements in mortgage foreclosure proceedings.

From the Industry's point of view, we welcome the measures taken by our leaders since they clearly reflect the spirit of the position that the Spanish Mortgage Association has been maintaining over recent years. The social drama that eviction causes to a household that loses its only home should be addressed with social measures limited to the specific segment that needs help, i.e. without a global reach that could harm the functioning of the mortgage market, its ability to collect debts and, ultimately, its funding, which is heavily dependent on international capital markets.

However, we must be constructive and say that there are many issues that could be reviewed in our market; in fact, some are already being analysed both at national and European levels:

- All of the legislative measures that ensure responsible lending and borrowing help prevent over-indebtedness and thus serve to reduce the number of foreclosure processes running, which is never desirable either for borrowers or lenders.
- The studies commissioned by various DGs of the European Commission on how to articulate in Europe different preventive and palliative measures of excessive indebtedness should be a starting point to discuss a possible scheme of "rearrangement" of the debts of the insolvent debtor, without damaging the functioning and efficiency of collection processes of European mortgage markets.
- In the Spanish case, it is likely that foreclosure proceedings must be "updated" to make them more transparent and public by removing current inefficiencies and, in turn, stimulating the use of other extrajudicial procedures which are equally effective and less costly.

Of course, there will also be other issues where achieving consensus with our counterparties will be more complex because of its harmful effects on the market, such as the introduction of compulsory *Datio in Solutum* (in Spain it has always existed with prior agreement between the parties), measures that hinder the effectiveness of legal procedures or the establishing of limits on the economic conditions of loans; all aimed at helping a group of mortgage debtors very limited in size - *in Spain only 3.38% of household credit for house purchases is in arrears* - to the detriment of a mortgage market that, even with its weaknesses, has allowed the financing of home ownership for more than 8 million households since 2000.

In any case, we hope to contribute to the debate on these and other issues relevant to our sector, with the ultimate goal of defending the effectiveness and efficiency of one of the largest and most important EU mortgage markets.

# Views on the Mortgage Market Review

By Paul Smee, Director General, Council of Mortgage Lenders

After more than three and half of years of consultation, in October the Financial Services Authority (FSA) issued PS12/16 – the final rules from its Mortgage Market Review (MMR).

The protracted period of consultation meant that its content did not come as a shock or surprise.

We were generally pleased that the FSA listened closely to the needs of the Industry as well as moderating a number of rules that would have been difficult to implement in practice, or were unduly restrictive.

But now the dust has settled slightly, what are some of the key areas likely to affect the Industry going forward? And are there lessons for the EU Directive on Credit Agreements Relating to Residential Property (CAARP) and its implementation.

### THE EU - INTERNATIONAL LEGISLATION AND REQUIREMENTS

The integration of a new regulatory framework in the UK with impending changes in Europe has caused concern for some time. With the EU Directive still in on-going discussions between the Council, Commission and Parliament, it is unlikely that we will see a finalisation of new EU rules until early 2013. What can be said though is that we agree with the FSA's view that the MMR is unlikely to be incompatible with the Directive in the majority of areas.

Essentially, we wanted to avoid a situation where UK firms were required to implement changes to systems twice over a very short period of time.

But one particular area that may need to be revised is disclosure. The Directive is likely to have a greater focus on disclosure and this is likely to mean that some further rule changes will be necessary in this area. The FSA proceeded with the approach of re-focusing the disclosure regime on key messages; but firms need to be aware that further information may be required to be given on top of this in the future.

We have argued for some time that the introduction of a European Standardised Information Sheet for Mortgage Credit (ESIS) would cost tens of millions of pounds in the UK alone with no obvious benefits for consumers – especially as the Key Facts Illustration (KFI) has existed in the UK market since 2004 and provided much of the framework for the proposed document.

The final MMR rules did ensure though that UK regulation reflected the key Financial Stability Board principles for sound underwriting.

### A "COMMON SENSE" APPROACH TO LENDING

The consistent theme flowing through the bulk of the rule changes is a push towards a more "common sense" approach to lending. Most of the market has already moved to reflect this new approach and has been operating to these standards for some time. What is also apparent behind that push is a new focus where the customer is placed at the heart of the market and where the system protects borrowers.

The new regulations are the most obvious sign of this shift in focus. But it's not the first time this has been spelled out. A quick flick through the recent FSA guidance consultation "Risks to customers from financial incentives" outlines a move away from an employee culture favouring financial incentives to one that is more in line with the customer's interest. The basic message in both documents is that the regulator would seek to reduce what it is sees as potential causes of consumer detriment.

As proposed, under the responsible lending rules lenders will now be required to carry out an affordability assessment as well as an interest-rate stress test, ensuring that borrowers can meet the repayments of the mortgage they want.

The removal of the non-advised sales process, however, may be trickier in terms of implementation. All interactive sales where there is a spoken or interactive dialogue with the consumer will be advised, but only if the lender has steered a customer towards a product, or where the customer wants a further advance.

### THE COST OF REGULATION

One unexpected outcome from the final rules was an increase in implementation and compliance costs for the Industry.

The FSA's reasoning was that they had previously underestimated the impact of removing non-advised sales. They revised their estimate of the cost slightly (both total on-going compliance costs and total one-off costs increased by £2 million pounds) to take into account the fact that some lenders have a much larger percentage of non-advised sales and may need to recruit additional staff.

The regulatory burden is costly and time consuming for large companies but far more exacting on small companies. The timeframe set out for the implementation of the new rules – 18 months – gives the Industry the necessary amount of time to prepare, but all that time will be needed.

Once the new regime has settled down we hope there will be a proportionate approach to regulation that relates to the risk that a business proposes.

### INTEREST-ONLY MORTGAGES

As expected, the FSA has broadly proceeded with the interest-only proposals unchanged from its previous consultation paper.

Borrowers seeking an interest-only mortgage will now need to have in place a clearly understood and credible repayment strategy, and have the potential capacity to repay the capital upon maturation. Importantly, the responsibility for repaying the capital will remain with the borrower.

By making it clear that the lender is not responsible for the performance of the repayment strategy, the FSA has eliminated any chance that borrowers could misinterpret any assessment of a repayment plan as an active endorsement.

The FSA will also proceed with a non-prescriptive approach to repayment plans. So while mere speculation of a house price rise will not constitute a credible strategy, lenders will have a degree of flexibility in how they assess repayment plans.

But what does this all mean? By increasing the regulatory burden, interest-only mortgages will end up where they're currently heading – regarded as a niche product. The FSA would probably prefer if that's where they stayed.

We believe there is still a market for interest-only in a number of different circumstances, but provided that borrowers who want to own the home outright don't select interest only on the basis of cost without a credible plan to repay the capital.

### LENDING INTO RETIREMENT

Despite discussion in the consultation phase, a mandatory age limit on customers after which a lending into retirement assessment would take

place, will not be applied. Instead, lenders can now base their assessment on the customer's actual expected retirement age rather than state pension age. Lenders will be expected to assess income into retirement to judge whether the affordability tests can be met.

An improved affordability test means that lenders will no longer have to "crystal ball gaze" about retirement age and it will also allow the lender more flexibility to consider a borrower's individual circumstances.

**CONCLUSION**

The Industry now has 18 months before the rules come into force on the 26th of April 2014. Lenders will need all of this time to establish and implement the underlying processes required by the new regulations.

Next year the FSA will be replaced by the Financial Conduct Authority (FCA). We hope that from a supervisory perspective the regulator will focus just as much on helping lenders and brokers to meet regulatory expectations as on enforcement action if rules are broken.

The EU Directive next year is likely to cause some rewriting of rules, especially in relation to disclosure.

We are generally supportive of the changes but as the broader industry already understands – and consumers need to be aware – the regulator has now permanently embedded a more conservative market.

# Overview of the Turkish Mortgage Market

By Umur Güven, Executive Vice President, Garanti Bank

In order to understand the Turkish mortgage market, one should start with analysing the following statement: "We expect that the Turkish mortgage market will grow by only 12% in 2012, which is the lowest rate since 2005".

Despite the financial turmoil which started in 2008 having had devastating effects on many countries around the world and which is still on-going in the euro area, the Turkish mortgage market has been growing with a cumulative average growth rate (CAGR) of 33% between 2005 and 2012. In Turkey, we can start talking about mortgages from 2005, based on the fact that the total outstanding mortgage volume was merely TRL 2,6 billion (EUR 1,4 billion) at the end of 2004. By the end of this year it is expected that the mortgage market will soar to TRL 84,0 billion (EUR 36,9 billion) and that the mortgages/GDP ratio will climb to 6,2%. Looking at this ratio, it is easy to predict that this double digit growth will continue in the coming years.

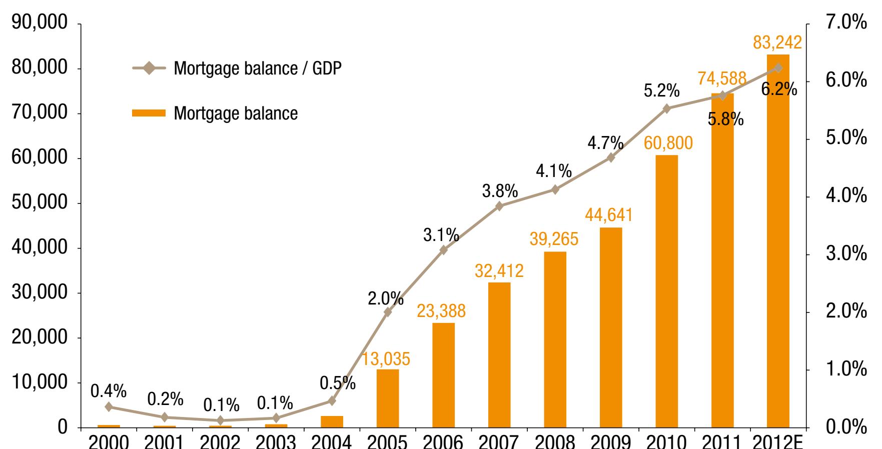
The main drivers behind this fast growth are the starting point of the Turkish mortgage market in terms of the significantly lower level of total outstanding mortgage loans in Turkey compared to other mortgage markets in Europe, coupled with favourable trends in demographics and expected developments in interest rates. Let us go through these aspects briefly.

Turkey, being a developing country, faced boom and bust style growth, high budget deficits, high inflation and high interest rates for almost four decades. Such an economic environment made the creation of a mortgage market impossible and resulted in a significantly low level of total outstanding loans on the Turkish mortgage market, which was almost non-existent until 2004.

The crisis in 2001 changed the entire political and economic landscape, enabling a more stable political environment and prudent economic policies. By 2004, many Turks experienced a single-digit inflation rate for the first time in their lives. Parallel to the shift in inflation, interest rates started to fall, which also triggered the mortgage market.

In Turkey, banks still announce mortgage rates per mensem (pm, i.e. monthly) instead of per annum (pa, i.e. yearly) and 1% pm has been considered as a psychological threshold. A mortgage rate of 12% pa (which is equal to 1% pm) is still high if you compare it with worldwide rates. However, it creates a very valuable alternative for being a homeowner for at least a certain part of the Turkish population. Currently, mortgage interest rates are above 10%

**Chart 1: Growth of Total Outstanding Mortgage Loans (Volume growth in TRL million) and Mortgage Balance to GDP Ratio**



and we expect that they will drop to 10% in the coming months and remain at this level during 2013.

Like in any mortgage market around the world, there is also a close link between mortgage rates and mortgage volumes in Turkey. We experienced a record growth of the mortgage market in terms of total outstanding mortgage loans (i.e. volume growth) of around TRL 15 billion in 2010, where mortgage rates were historically at their lowest levels as shown in Chart 3. In 2013, as a decrease in interest rates to the levels of 2010 and 2011 is foreseen, we expect that the Turkish mortgage market will grow by TRL 10 - 12 billion.

The last and maybe most important factor for growth is demographics. By the end of 2011, the Turkish population grew by 1,36% (i.e. by more than 1 million) to 74.7 million. This growth trend will continue - though at a slower pace - for at least another two to three decades. Half of the population are aged below 30 and 80% of the population live in urban areas. Average household size is four persons but it is decreasing. 40% of the existing housing stock is old and deficient, and must be renewed in the coming years. All of these statistics translate to a demand for housing of approximately 700,000 units/year. This is also the reason why the Turkish mortgage market is continuously growing despite the financial crises and relatively high interest rates.

### CHALLENGES IN 2013

The Turkish mortgage market is a fixed rate market where almost every loan has a fixed interest rate for the entire term. Although there is a possibility under the Mortgage Law dated March 2007 to disburse loans in variable rates, the Central Bank of Turkey opted to set the interest rate base for those loans at the level of the Consumer Price Index (CPI), which made it difficult for banks to fund these kinds of loans and sell them at more favourable rates than fixed rate loans. Therefore, the market, on general, remained a fixed rate market.

Due to the significant volatility of interest rates and the fact that banks disburse loans at a fixed rate for the entire term of the loan, there is a tendency that consumers refinance their loans when the interest rates start to decrease. We are currently experiencing this cycle. During the second half of 2009 and first half of 2011, Turkish banks refinanced or re-priced almost half of their existing portfolio. As can be seen on Chart 4, we expect a similar trend, however to a smaller extent, in 2013. Although there is a prepayment penalty of 2%, it does not have a significant impact on customers' choice given that the difference between the original and the existing interest rates is greater than 1% pa.

Due to the fluctuation of interest rates and the fact that consumers will choose to borrow at a fixed rate, this refinancing phenomenon is expected to remain the characteristic of the Turkish mortgage market, challenging the banks to predict interest incomes from these loans and therefore to develop their financial plans.

**Chart 2: Interbank O/N Rates, Inflation and Mortgage Interest Rates**

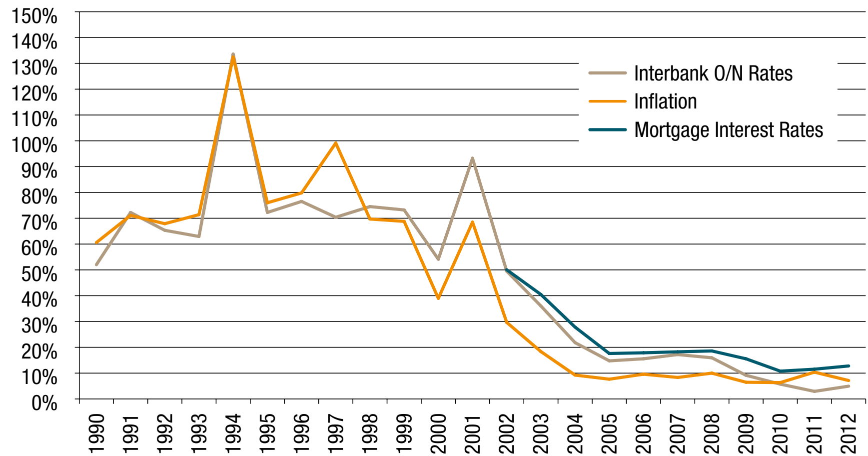



**Chart 3: Growth of Total Outstanding Mortgage Loans (Volume growth) and Mortgage Interest Rates**

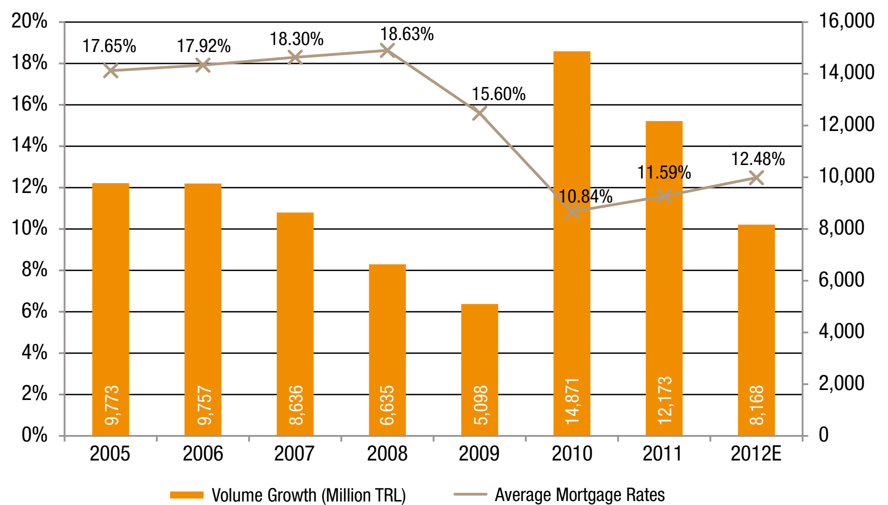
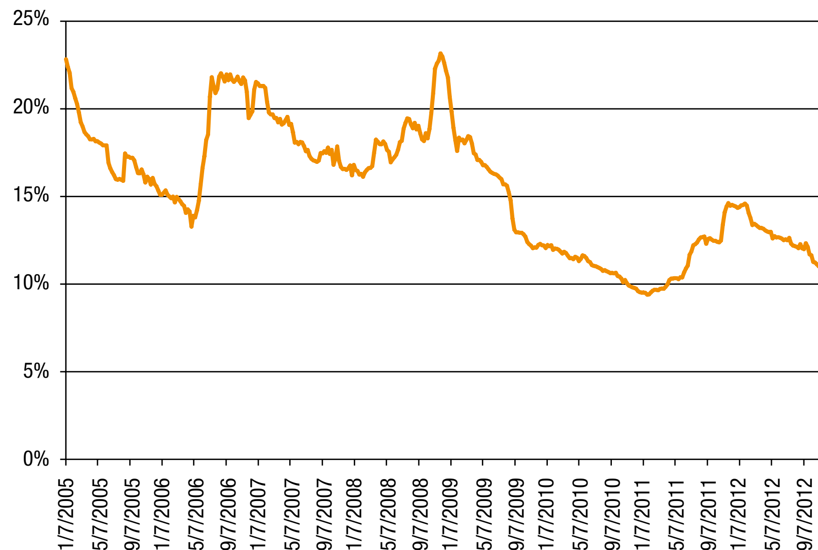



**Chart 4: Mortgage Interest Rates – Time to refinance?**



Another important challenge for Turkish banks, maybe not in 2013 but surely in the next couple of years, is their funding. The share of mortgages on banks' balance sheets is still small, around 11%, but they are growing faster than deposits, which are the main funding source for most of the banks. The ratio of credits to deposits is now over 100% and banks started to look at other financing alternatives, such as corporate bonds. Despite this steady growth, there is no issuance of a secondary mortgage market instrument, although there is an existing legal framework for Turkish covered bonds and mortgage securitisation. The main obstacle for creating a Turkish mortgage secondary market is the following: currently, all disbursed mortgages are in local currency, TRY (i.e. Turkish banks' long-term funding demand is more in TRY), while the few investors - which are typically non-domestic - are generally only willing to invest in mortgage secondary market products denominated mainly in EUR or USD. Therefore, moving forward, the challenge for Turkish banks is not only to make this product attractive to foreign investors but also to encourage local investors, in particular banks buying bonds from each other or from the central issuing entity.

There is an initiative by the Banking Association of Turkey to create a Central Issuing Entity and kick-start the secondary mortgage market in Turkey. By creating such an entity, it is intended to develop a more liquid market, reach a broader local investor base and establish higher confidence in the instruments to be issued.

To summarise, the Turkish mortgage market is a very interesting, fast-growing market facing a number of challenges and, at the same time, it offers a number of opportunities both on the primary and secondary market sides, so it is well worth mortgage experts keeping a close eye on it.

# Expected Report, Partly Unexpected Recommendations and Unintended Consequences: the potential impact of the Liikanen recommendations on the mortgage credit industry

By Katalin Dobranszky-Bartus, Acting Head of Economics,
& Jennifer Johnson, Head of Legal Affairs, European Mortgage Federation

One year after the publication of the UK's Vicker's Report and a couple of months after the introduction of the US' Volcker Rule, the High Level Expert Group on structural aspects of the EU banking sector established by the European Commission and chaired by Errki Liikanen, Governor of the Bank of Finland, finally published its report on the 2nd of October 2012.

The Liikanen Group, which was tasked with assessing whether or not structural reforms of EU banks are needed in addition to the ongoing regulatory reforms, made the following five, central recommendations:

- Mandatory separation of proprietary trading activities and other significant trading activities;
- Additional separation of activities conditional on the recovery and resolution plan;
- Possible amendments to the use of bail-in instruments as a resolution tool (proportion and definition);
- A review of capital requirements on trading assets and real estate related loans; and
- Strengthening the governance and control of banks.

The mortgage credit industry supports the European regulators' objectives of establishing a stable and efficient banking system serving the needs of citizens, the economy and the internal market. However, the Industry is extremely concerned that some of the proposed Liikanen measures would be detrimental for the European mortgage industry, for consumers and potentially for the wider economy, by undermining the Industry's essential role in sustaining economic recovery and providing wider access to homeownership in Europe.

The European Mortgage Federation therefore welcomed the opportunity to express its concerns in a response to the consultation, which was launched with a deadline of mid-November 2012. This consultation forms part of the Commission's process for assessing the Group's report and recommendations. In its response, the EMF commented[2] on the following three sets of measures: 1) the treatment of mortgages; 2) the proportion of bail-inable debt; and 3) the mandatory separation of the traditional bank and investment bank.

Indeed, the measures proposed by the Liikanen Group in these three areas could have far reaching implications for the EU mortgage industry as the very existence of some long-standing business models could be jeopardised, while the ability of others to continue to lend to the real economy could be

2 EMF Response to the Consultation on the Recommendations of the High-level Expert Group on Reforming the Structure of the EU Banking Sector, 9 November 2012.

severely constrained. These outcomes are contrary to the importance the Liikanen Group itself places on diversity in the sector: "*The EU Banking sector is diverse, which is valuable*"[3].

In a nutshell, these concerns are as follows:

**UNINTENDED CONSEQUENCES FROM APPLYING MORE ROBUST RISK WEIGHTS AND LTV RATIOS**

Eventual increases in risk weights for residential and commercial mortgages could be disruptive and lead to reduced lending capacity, particularly for specialised lenders. The Industry recognises that, in some countries, systemic banking crises were the result of excessive lending. However, the EMF remains convinced that mortgage lending remains a typically low-risk asset class in the vast majority of member states.

Furthermore, IRBA risk weights are the result of rating models which are thoroughly assessed and approved by supervisors. Therefore, in principle, these models already reflect known loss experience incurred in recent real-estate driven crises, where relevant to the particular institution and Member State. Against this background, ensuring that the feedback from known loss experience into IRB PDs, LGDs and risk weights is robust would appear to be a better, more logical approach than applying arbitrary floors as the Expert Group proposes.

While the Industry acknowledges the Liikanen Group's focus on providing for precautionary measures, it should not be forgotten that those mortgage lenders who use internal rating based models to define their risk weights are typically the biggest lenders on a given market. Therefore, increasing the risk weights for these lenders would disproportionately affect that real estate market. Consequently, such proposals should be exercised with caution, as they could in fact significantly hinder European economic recovery.

In addition to questions surrounding the impact of higher risk weights, the Industry has concerns regarding the Liikanen Group's proposals in relation to LTV/LTI caps. While it is common for individual lenders to use LTV/LTI ratios as important risk assessment criteria, the EMF shares the Financial Stability Board's view[4] that it is not necessary for regulators and supervisors to mandate such caps if they satisfy themselves that the underwriting standards are sufficiently prudent and are unlikely to be eroded under competitive pressure. Indeed, the Industry is concerned that LTV/LTI caps could in some cases unnecessarily restrict access to credit for borrowers. Indeed, these ratios cannot be used rigidly by lenders because there is no 'one size fits all' figure which could be appropriate for each and every borrower. However, this does not preclude jurisdictions from considering imposing or incentivising limits on LTV/LTI ratios according to specific national circumstances. However, in such cases, LTV/LTI limits alone should not be determinant in the decision to grant the credit, but, as indicated above, should be included in the overall creditworthiness assessment in the interests of genuine responsible lending.

**BAIL-INABLE DEBT: SHARING THE BURDEN?**

The Liikanen Group strongly supports the use of bail-in instruments within the scope of the Bank Recovery and Resolution (BRR) Framework, which would give power to write down claims of unsecured creditors or convert debt claims to equity topped up with the Commission's BRR Proposal, which requires a minimum amount of "bail-inable" assets as a proportion of the total liabilities.

In particular, this requirement would place specialised mortgage lenders in a difficult situation as a higher ratio might not be compatible with the liability structure of their balance sheets which largely consist of covered bonds with little or no senior unsecured debt.

The compulsory provision of bail-in eligible liabilities might lead to a situation where fully or partially secured real estate financing would be refinanced by unsecured debt, therefore significantly increasing the risk of the business model, the cost of funding and, as a consequence, the cost of mortgage lending.

On the top of all of this, the bail-in tool is primarily intended to address interconnectedness and systemically important banks with the aim of protecting depositors. However, a number of specialised European mortgage lenders do not or do not significantly base their funding on deposits, therefore this resolution tool has negligible or no added value in their case.

**BETWEEN VICKERS AND VOLCKER: MANDATORY SEPARATION OF TRADITIONAL BANKING AND INVESTMENT BANKING ACTIVITIES**

The recommendations of the Expert Group are intended as a "one size fits all" solution applicable to the EU as a whole, therefore not taking into account the great heterogeneity of the 27 Member States in terms of business models and, consequently, affecting local business models that continued to perform well during the crisis.

In this context, the criteria used in the Liikanen Report for determining which trading activities in which banking groups are to be separated from core banking activities, i.e. the proportion of "assets held for trading and available for sale" to total assets, may prove too simplistic.

In many countries, the funding of mortgage lending is based on the issuance of covered bonds through which the mortgage lenders transform illiquid mortgage loans into liquid assets. These liquid assets appear in banks' trading books (instead of their banking books as loans). This means that, from an accounting perspective, trading books would appear to be larger for banking groups operating in countries where covered bonds are used as the main funding tool of mortgage loans, than for banking groups operating in countries where deposits are channelled directly to fund mortgages.

As such, the application of the Expert Group's criteria to a heterogeneous market would cause the structural characteristics of the banking system to affect the ranking of banks. Accordingly, a mortgage system that has proven stable during the crisis would be disadvantaged by the use of the proposed criteria of "assets held for trading and available for sale" to total assets. A mandatory separation of, for example, market making activities of mortgage bonds into a new legal entity may have unintended consequences for the liquidity of the system and ultimately financial stability.

3 High-level Expert Group on reforming the structure of the EU banking sector, Final Report, Brussels, 2 October 2012. P32.

4 See Financial Stability Board Principles for Sound Residential Mortgage Underwriting Practices, adopted in April 2012.

# ECBC

# The Austrian Covered Bond: a niche product

By Jörg Bayer, Raiffeisen Bank International AG for the Pfandbrief & CB Forum Austria

**ECONOMIC OVERVIEW**

Austria's economy is characterised by solid structural fundamentals. While Austria benefits from a comparatively high share of the manufacturing sector, the composition of GDP does not signal any imbalances. Spending on research and development is high (2011: 2.8% of GDP) when compared to other euro area countries. The favourable structural position is reflected in Austria's constant current account surpluses. The country's unemployment rate is currently the lowest in the entire European Union and household debt in terms of GDP has been declining for two years. While real estate prices increased noticeably since 2005 (mainly in Vienna), this was not accompanied by overly rapid mortgage loan expansion.

**REAL ESTATE MARKET**

The Austrian housing market has, for decades, been quite stable, despite some of the obligatory ups and downs. So while house prices in Ireland, Spain and Denmark have increased dramatically in the past, in Austria the real estate market has seen no comparable exaggerations. Real estate prices in Vienna increased by a total of 5% (versus approximately 6% in the rest of Austria) from 2000 to 2005. Around 2005, this stable trend changed to a steady upwards trend, which was stronger in Vienna than for the rest of the country. In Vienna, prices rose by 57% from the beginning of 2005 to 2011, while prices in the rest of Austria during this time saw increases of "only" 26%. In 2010, the upwards trend increased significantly again. From the beginning of 2010 until Q3 2012, prices jumped by 31% in Vienna (versus 14% in the rest of Austria). This seems to be driven more by inflationary fears and the low interest rate environment than from return expectations. This price boom is concentrated in the residential segment. The development of the commercial property segment is not so positive by a long way. For instance, in some Austrian federal states the rents of commercial real estate even declined during 2011.

Not taking Vienna into consideration, prices in western Austria are clearly higher than in the eastern part of the country. Besides Vienna (especially the first district in the city centre), prices in Innsbruck and Salzburg represented the upper end of the house price scale.

Despite these significant price increases, we do not believe in a real estate bubble because of various mitigating factors. First of all, it seems that many real estate investors buy their properties with cash and not with the support of loans. Another fact is that the Austrian housing market was cheap in comparison to most other European countries prior to the strong jumps in prices. Also, the economic parameters in Austria look healthy in the difficult environment that currently defines Europe. In the case of Vienna, the figures show the same trend as other cities in Europe (especially large German cities).

**COVERED BONDS (PFANDBRIEFE)[5]**

In Austria, covered bonds (CBs) have a long history under the name Pfandbriefe. Legislation for Austrian CBs (Pfandbriefe) exists since 1874. At present, Austria has three different CB frameworks and a harmonisation process is underway. At the end of this process, Austria should have one standardised legal framework under which all legitimised banks will issue their CBs. For foreign investors especially the Austrian CB market will improve its transparency through this process. We believe that this harmonised legislation will only bring advantages to investors.

All Austrian CB frameworks are very similar to their German counterparts. The assets stay on the balance sheet of the issuer and are not transferred to a separate legal entity (SPV) like in the UK, Italy or the Netherlands. In the event that the issuer goes bankrupt, CB investors have a preferential claim on the assets. The assets of the collateral pool are separated from the rest of the entity/assets and a collateral pool administrator is also appointed.

In comparison to other countries, the Austrian CB market still seems to be at the beginning of its development and has a strong future growth potential when compared with other countries of a similar size. As of year-end 2011, outstanding CBs in Austria amounted to around EUR 40 bn (Norway: EUR 96 bn; Switzerland: EUR 72 bn; Sweden: EUR 209 bn). In 2011 alone, the Austrian CB market saw significant growth of 46% year-on-year. The mortgage CB market itself grew by 64% in 2011. However, Austria is still one of the few countries where the majority of the outstanding CBs were public CBs. In Q2 2012, the public CBs

5 For comparison purposes all covered bond figures are based on the ECBC or the Austrian Pfandbriefforum.

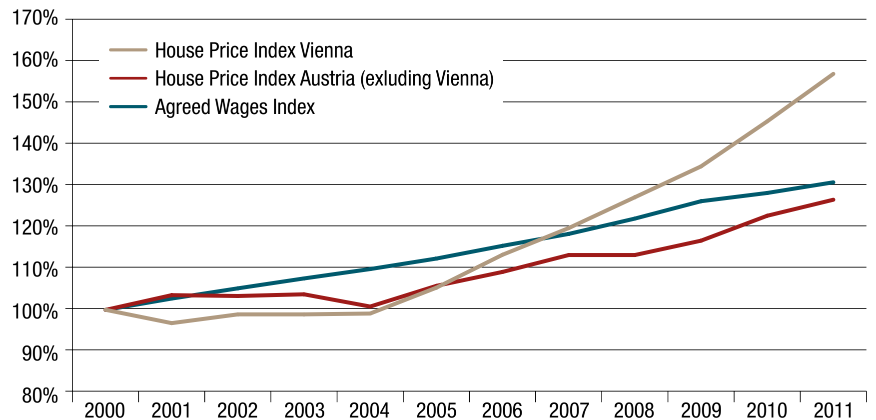
represented 65% of all outstanding CBs. In 2006 this share was even higher and stood at 80%. Thus, it is not surprising that we also expect the mortgage CBs to be the driver of growth in the coming years.

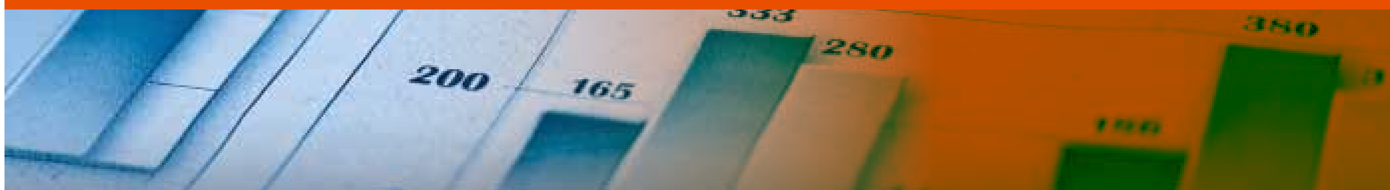
At the moment, sixteen Austrian banks have outstanding CBs. The biggest players on the Austrian CB market are the Erste Group Bank and UniCredit Bank Austria. At present, these two entities represent more than half of the whole Austrian CB market. The situation looks different when the CBs are split between public and mortgage CBS. In the public CB segment, UniCredit Bank Austria is the biggest issuer followed by the government-owned Kommunalkredit and the HYPO Niederösterreich Group. In the mortgage sector, the Erste Group Bank is the dominate issuer and represents more than half of the domestic market. Together with UniCredit Bank and HYPO Oberösterreich, these three issuers are responsible for more than 90% of the Austrian mortgage CB market.

The collateral pool of Austrian mortgage CBs consists of 90% domestic mortgages followed by German mortgages (4% of the total pool). In Austria, mortgage loans in Swiss francs (CHF) play an important role as 17% of the collateral pool is denominated in CHF (this is the only major foreign currency present).

Furthermore, despite the fact that there are some indications of a slightly overheated real estate market in certain regions, we still believe that Austrian CBs as a whole represent a very safe product for investors, especially when one takes into account the high overcollateralisation levels of the majority of Austrian covered bonds.

**Chart 1: House Price Development in Austria**





# NEWS IN BRIEF

## London Economics Delivers Final Over-Indebtedness Study to DG MARKT's FSUG

Readers will recall that earlier this year, DG Internal Market's Financial Services User Group (FSUG) commissioned a Study on the Means to Protect Consumers in Financial Difficulty with a view to identifying solutions which will allow over-indebted consumers to return to a financially sustainable path by eliminating some or all of their debts. On the 13th of November 2012, London Economics, the Consultant tasked with carrying out the Study, delivered its Final Report to the FSUG. The next steps in terms of the Report's publication date and follow-up are not yet known, but it is anticipated that the FSUG will draw on examples of 'best practice' identified by the Consultant, to potentially issue policy recommendations. Look out for next month's Mortgage Info for the very latest information!

## EMF Annual Conference 2012

On the 14th and 15th of November, the European Mortgage Federation celebrated a decade of its Annual Conferences with the holding of the 2012 edition of the event. Over 120 delegates from across Europe and beyond convened in Brussels to listen to the views of a diverse range of stakeholders in the European mortgage credit industry, all of them experts in their field. Individual panel sessions focused on the role of housing finance in the wider economy, tackling over-indebtedness, the prudential regulatory framework – leverage ratio and liquidity issues, and the Covered Bond Label initiative. A keynote address by Associate Professor Andrea Resti of Bocconi University, Milan, titled "New Liquidity Rules and Mortgage Finance: Dangers and Opportunities" was a particular highlight of the event.

Next month's Mortgage Info will be a special EMF Conference edition, with full summaries of the day's discussions.

## Shadow Banking Attracting Global Attention

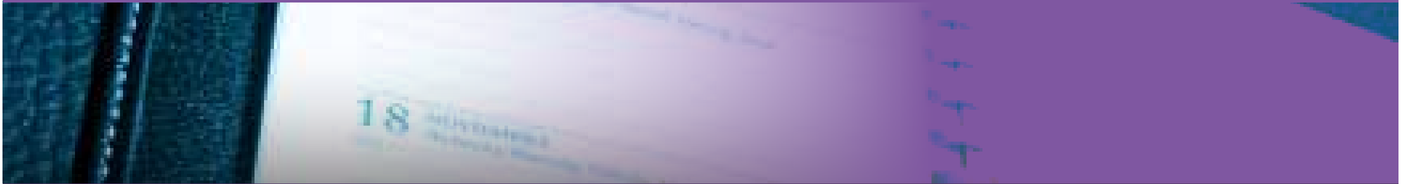
The Financial Stability Board (FSB) published its "Global Shadow Banking Monitoring Report 2012" on the 18th of November 2012. The Report shows that non-bank financial intermediation grew rapidly before the crisis (in parallel with the regular banking system), from an estimated USD 26 trillion in 2002 to USD 62 trillion in 2007. This has continued to increase since, although at a slower pace, to USD 67 trillion at the end of 2011. The Report also concludes that there is considerable diversity in the relative size, composition and growth of non-bank financial intermediaries across jurisdictions.

In addition to this Report, on the same date the FSB published its "Initial Integrated Set of Recommendations to Strengthen Oversight and Regulation of Shadow Banking" for consultation. The Recommendations focus on five specific areas in which the FSB believes that policies are needed to mitigate the potential systemic risks associated with shadow banking:

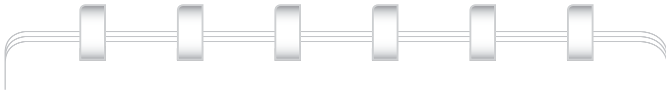
1. To mitigate the spill-over effect between the regular banking system and the shadow banking system;
2. To reduce the susceptibility of money market funds (MMFs) to "runs";
3. To assess and mitigate systemic risks posed by other shadow banking entities;
4. To assess and align the incentives associated with securitisation; and
5. To dampen risks and pro-cyclical incentives associated with secured financing contracts such as repos, and securities lending that may exacerbate funding strains in times of "runs".

To recap, in Europe, the first steps towards regulating shadow banking have already been taken. On the 19th of March 2012, the European Commission published its Green Paper on Shadow Banking, in response to which the European Parliament - with the help of its Economic and Monetary Affairs Committee - presented its own-initiative report on the 20th of November 2012, highlighting the challenge of defining what shadow banking is.

The full Report can be downloaded via the FSB website here.



# AGENDA



## DECEMBER

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|---|---|
| 05/12 | European Parliament Financial Services Forum (EPFSF) event on The Banking Union, Brussels |
| 12/12 | European Covered Bond Council (ECBC) Steering Committee Meeting, Brussels |

## JANUARY

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|---|---|
| 28/01 | European Banking Industry Committee (EBIC) Plenary Meeting, Brussels |
| 31/01 | 11th Annual European Financial Services Conference, Brussels |