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'Collective amnesia' on mortgage reform

Posted by **Tracy Alloway** on Jul 05 10:58.

German [financial consultant](#) Achim Dübél doesn't mince his words.

Last week he spoke to a group of European politicians, including representatives from the UK, Spain and Germany, to talk mortgage reform. In particular, he was presenting a new paper, written together with Marc Rothemund, and published by the Centre for European Policy Studies (CEPS). It's a big deal given the current [consumer protection debate](#) on European mortgages, and the European Commission's [recent interest](#) in the cost and benefits of various mortgage credit policies.

The [full report](#) is 80 pages long, but Dübél has helpfully sent us a summary:

- We focus in regulation (Directive proposal) on transparency as the smallest common political denominator, while house price valuation, loan underwriting and loan product mix have demonstrably shown similar defects in large parts of Europe as in the U.S. That is we fight a massive injury with band aid.

- In particular we do nothing in Europe to address the massive conflict of interest for central banks when the dominant product in the market are variable-rate mortgages, whose financial conditions central banks can directly change (via the predominant indexation to interbank or even central bank rates). This means that currently European default rates are artificially depressed, and we lose incentives to reform. Central banks are essentially the largest landlords in 2/3 of Europe and thus highly exposed political stakeholders. On the one hand this provides them with political powers that they might enjoy, but at the same time it puts them into a political straightjacket by eliminating any realistic notion of monetary policy independence. A good example is the Bank of England, but the ECB – with Ireland and Spain around their neck – is essentially in the same shoes.

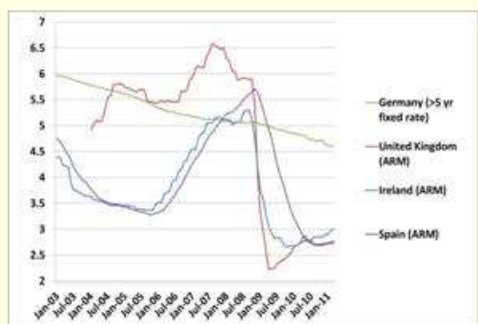
- In combination of the dominance of variable-rate lending with other underwriting defects, such as 'open market valuation' and unrestricted product risk layering (interest only, high LTV and so forth) the consequence of the conflict of interest is too lax monetary policy and a constant sequence of boom-bust in the sector, with far-reaching implications for the wider economy.

- Consumer protection regulations can be one important cornerstone to establish a more stable system, by limiting the downside for consumers ex-ante (rather than ex-post, often through political intervention) and thus raising the cost of credit in a sensible way against delivering a minimum of risk protection. This would delink mortgage products from short-term interest rate fluctuations and thus help central banks to regain their autonomy and steer the economy in a more responsible way.

You can see what Dübél's getting at, with this slide from last week's presentation:

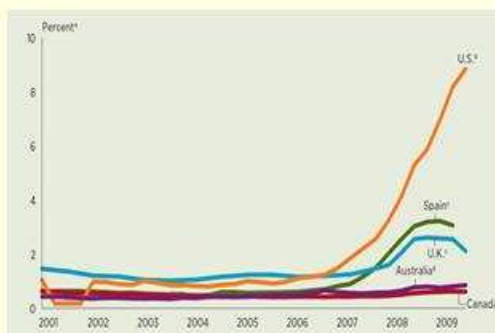
Have the combined consumer / bank bailout policies within the EU created amnesia regarding mortgage reforms?

Interest rates on outstanding loans in the dominant national mortgage portfolios in four European countries, 2003 – 2010



U.S. median interest rate 2010 ca 5.75%.

Mortgage default rates, 2001 – 2009



Mortgage market crisis management & regulation efforts

Policy option	United States	Europe
Central bank policies	'Unsuccessful' Fed bailout as credit crunch pre-empts prepayments; lender recapitalization is priority.	'Successful' ECB/BoE bailout as ARM react directly to rates; yet conceals structural consumer insolvency (inability to pay normal rates).
Fiscal policies	FHA refinancing of private Subprime. Restructuring programs HAMP/HARP. GSE/mortgage tax deduction reform (?). Fed buys/repos w Treasury guaranty.	ECB credit easing (private ABS repo, covered bond purchases). ESFS backs nationalization of bank debt. National write-down policies/bank recaps.
Legislation, general	Dodd-Frank, interagency guidances.	Proposed EU Directive, EBA rules pending (?).
Legislation, transparency	Single-page information sheet (plan).	ESIS and APRC mandatory.
Legislation, underwriting	Qualified residential mortgage (LTV limits); specific responsible lending rules (fully-index/amortizing).	Responsible lending rules in proposed EU Directive. Wide national discretion range (ex. Forex, from ban, HU, to stress-testing, PL).
Legislation, products	ARM caps mandatory. Prepayment penalties on high-rate loans outlawed.	UK: non-conforming ban (?), forex bans in AT and HU. Suitability criteria via EU Directive (?).
Legislation, funding	Basel III (leverage ratio), skin in the game f. MBS, covered bond law	CRD (leverage ratio unclear), skin in the game f. MBS
Foreclosure prevention	De-facto foreclosure moratoria and restructurings.	De-facto foreclosure moratoria and restructurings (IRE, LAT, HU).
Institution-building	Consumer Financial Protection Bureau	None (in consumer protection)

The presentation isn't available on the CEPS website but we've stuck it in [the usual place](#), for those who are interested. On a broader note, the paper *does* have some interesting forward-looking things to say about variable rate mortgages. According to Dübel, central bank policies "are heavily contributing to the incidence of default" in Europe. Irish borrowers, for instance, only paid a 2-2.5 per cent interest rate on the two thirds of the mortgage portfolio tied to the European Central Bank's refinancing rates.

In Spain, meanwhile, borrowers pay even less than in Ireland despite [interest rate floors](#) on a third of contracts. British and [Danish mortgage rates](#) don't exceed 3 per cent. In contrast, in France and Germany, the average mortgage rate is usually

the range of 4 to 5 per cent. The variation in lending rates (you guessed it) makes for a somewhat tiered European mortgage market.

Or, as Dübel puts it:

*The combination of these factors suggests a fragile situation. **High-levels of shadow default inventory are likely in the most affected jurisdictions, i.e. structurally over-indebted households who are being kept afloat by central bank assistance lowering the payment-to-income ratio.** Interest rate increases moving up payments have been announced by Irish lenders in the reviewable-rate portfolio; they also have attempted to generate a prepayment wave of index-trackers, which are loss-making. The combined effect together with relaxing legal liability for residual debt is expected to push default rates higher. In Spain, Euribor-linked mortgage rates are gradually increasing; an interviewed lender comments that the room for manoeuvre for rate increases, before defaults are expected to increase again, is perhaps 1%. **The question is therefore highly relevant of how much additional scope there is in Europe for house price adjustment because delayed foreclosures come to the market as interest rates rise going forward, or because the legal foreclosure regime is unchanged.***

If you have time, and if you want to learn about the mortgage policies which were arguably at the heart of the recent financial crisis and how Europe may try to fix them, the [whole paper](#) is well worth a read.

Related links:

[S&P sees eurozone, UK housing headwinds on swelling rates](#) – FT Alphaville

[How big the BoE's interest rate bind?](#) – FT Alphaville

[A 75bps rate rise could cost consumers £6.2bn, Deutsche says](#) - FT Alphaville

This entry was posted by [Tracy Alloway](#) on Tuesday, July 5th, 2011 at 10:58 and is filed under [Capital markets](#). Tagged with [central banks](#), [consumer protection](#), [ecb](#), [eurozone](#), [financial reform](#), [foreclosures](#), [interest rates](#), [mortgages](#), [US mortgages](#).

Comments

Goladaman's points are entirely fair - low interest rate policy is about helping the majority of mortgage holders rebuild their balance sheets and the benign neglect of moderate inflation is part of it. The UK has lived beyond its means and eroding the real cost of the public sector and the debts involved is how they will be bought back into balance. But depriving the UK economy of an effective monetary policy reaction function would have resulted in mass unemployment. The question remains, what would have happened if we had all been on fixed mortgages? The answer is it would have been a economic catastrophe. Admittedly a few rich pensioners on fixed pensions might have enjoyed the deflation; renters and the poor would largely be unemployed.

I saw a good post a while back arguing that this low rate policy is basically robbing the poor through inflation on basic items whilst saving the middle classes through reduction of mortgage interest payments. I think this is a fair assessment so I dont agree with DancingMonkey that the policy has been entirely helpful. For anyone who owns a home outright, rents a home, lives on fixed income etc (so old people, poor people etc) and anyone who isnt in debt the policy isnt exactly helpful. It just depends which side of the fence you sit on. And believing what is convenient for oneself isnt the same as whats true.

"the mortgage policies which were arguably at the heart of the recent financial crisis" - couldn't agree more. Many thanks for the article & links - great post.

Let's just imagine what would have happened to the UK if everyone had been on fixed mortgage. Monetary policy would have been effectively neutered and would have been like pushing on a string; and the UK would be up a creek without paddle as we fell into a 1930s liquidity trap. I think we are actually better off with variable rate mortgages and I'll be keeping mine for next time thank you very much Mr Dübel.

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