

Promoting European Mortgage Market Integration – an Economist’s Perspective

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Do we need integration?

The series of studies in which the author participated in the past decade tried to shed light on the various arguments. At their heart was the empirical relationship between European market integration on the one hand and domestic market efficiency, completeness and growth on the other hand

The studies were able to demonstrate that while integration remains weak, domestic efficiency and in particular completeness have room to improve.

Key efficiency issues identified were the high industry concentration levels, raising the danger of future oligopoly pricing, and the cross-country variation of funding costs, risk costs and adjusted prices. For example, while the 64 bp adjusted price variation result in Mercer’s 2003 study appears moderate – hence the assessment of European markets as ‘broadly efficient’ – it must be contrasted with lenders competing over 5 or 10 bp in many markets.

Concerning completeness, the studies found little evidence for the claim that consumer preferences, rather than

regulation, were causal for the observed large gaps in domestic product menus.

As product innovation is driven by new market entry, including foreign, this area was identified as potentially yielding large gains for growth. Reduction of funding and other costs would add to those gains.

How can we achieve integration?

Integration is currently critically undermined by the unevenness of the legal-regulatory European playing field. More specifically, the Second Banking Directive and its concept of mutual recognition have failed to work for the mortgage sector. A majority of stakeholders in the integration debate have come around to accept this fact, many reluctantly.

Accepting failure at the same time shows the way forward. Rules ought to be written that establish *common minimum* legal and regulatory standards for the European mortgage market.

The common minimum should be truly a minimum in the sense of creating a low-cost infrastructure for private

transactions, both in the primary and secondary mortgage market. It should include measures to enhance transparency, to improve legal security and tradeability of collateral and financial claims, to reduce transactions costs as well as to enable unfettered access to data.

Standardization of products and practices is only desirable if it leads to improvements in this transactions infrastructure. Examples are the introduction of the Eurohypotec, common property valuation rules, and minimum standards for MBS and covered bonds. Deregulation in areas that block competition would complement this reform package.

Integration and the General Good

But how could a lean integration package be reconciled with the interpretative sovereignty of the Member State over the General Good, especially in the name of the consumer? This is the dilemma created by the Rome Convention, whose reform is hotly debated among stakeholders.

Rather than altering the fundamental legal architecture of the EU, it would be more productive to search for an objective definition of what constitutes a violation of the General Good.

In order to achieve this goal, it would be necessary to identify an empirical proxy for the violation of the General Good and underpin all proposed regulation that go beyond the common minimum with empirical evidence as to their impact on the proxy, following a common methodology.

In the central area of consumer protection, for example, default risk is a good candidate for a proxy and the empirical models used for assessing default in mortgage finance define a suitable methodology. The models are able to map the impact of a large variety of risk factors, such as house prices, loan volumes and currency, income and interest rate levels, and can be flexibly adjusted as the risk environment changes (e.g. due to inflation). Regulation intended to contain individual default risk factors would explicitly refer to the critical threshold values identified by the models.

A decision would be reached through a clearly defined interaction process between competition watchdog, the Commission, and protector of the General Good, the Member State. The Member State, who desires to apply stricter regulation, would appeal to the Commission and provide empirical evidence within the defined methodology. The Commission would accept or reject the appeal in a procedure that could be structured in analogy to Articles 87 and 88 of the EU Treaty with regard to state aid. These articles are among the most successful elements of the Treaty.

Will it work?

The question must be raised whether not market factors, such as entry-detering pricing policies or fixed costs of distribution networks, dwarf the net benefits that *any* legal-regulatory program may have. This could well turn out to be true, although – as the technological progress and pace of restructuring of the industry suggests - it is not particularly likely. In any case, as

long as the major roadblocks are not removed, we will not know.

A fundamental alternative to the proposed program that is *known* to have overcome *both* legal-regulatory and market fragmentation would be to create centralized mortgage market institutions, along the lines of the U.S. agency system created in the 1930s. Compared to the substantial fiscal and adjustment costs imposed by a centralized system, however, the likely implementation costs of a legal-regulatory program for the industry appear modest.

Relevant for political success is finally the question of who would be the

winners, and who the losers of reform. If we divide the European mortgage industry into large universal banks operating on a European scale through subsidiaries, mortgage specialists operating currently mostly in their national markets, and purely domestic universal banks, the answer is obvious: it is the specialized industry that should expect the largest benefits from a greater potential market for its products, one that does not require the substantial amounts of capital needed to buy foreign subsidiaries. The other large group of winners – through greater competition and product innovation – would be consumers.