EUROPE

Recent Developments in European Mortgage Markets

by Judith Hardt

European property and mortgage markets are structurally very different for many reasons. Powerful factors are at work bringing about significant changes. These factors include:

- Deregulation and consolidation.
- The internal market.
- The single currency.
- The e-economy.
- Revised bank capital requirements.

Deregulation of the financial services sector continues at an unequal pace across Europe. Consolidation or cross-border mergers and acquisitions are a more recent feature despite reluctance on the part of certain governments to liberalize their markets and a desire to encourage national champions.

The achievement of an internal market in the provision of financial services, including mortgage credit, remains an ongoing process as does growth in cross-border business such as commercial property lending. The European Commission's latest attempt to achieve an internal market, the 1999 Financial Services Action Plan, has, some would argue, an overly ambitious completion date of 2005.

Judith Hardt is the Secretary General of the European Mortgage Federation.[1] This article is based largely on "Hypostat 1989-1999," a 10-year statistical survey on mortgage and property markets in the European Union, published by the European Mortgage Federation.

The introduction of a single currency 18 months ago has led to increasing integration of both the EURO-11 and the 15 hitherto autonomous economies. The single currency has major implications for European property markets and the financial systems that serve them. Property and mortgage markets remain intrinsically domestic, although as we move towards the creation of a deep and liquid single capital market this will change with property portfolios valued in euros across Europe and loan books bought and sold in euros.

Greece will join the third and final stage of EMU on January 1, 2001. And if the Danish electorate vote in favor of the Euro in the September 28 referendum, the most likely date for Denmark's EMU entry is estimated to be January 1, 2002. The accession countries will have to complete all three stages.

The impact of a combination of e-commerce and technology on mortgage lenders and mortgage borrowers looks likely to reconfigure the mortgage credit sector and the way lenders do business.

Since the vast majority of mortgage loans remain on the balance sheets of European lenders, the current review of bank capital requirements is of fundamental importance for mortgage lenders.

This paper will, therefore, seek to:

- Highlight the major differences between European mortgage markets.
- Explain the principal funding mechanisms which serve them.
- Examine the potential impact that the factors of change will have on future developments.

EUROPEAN MORTGAGE MARKETS

Mortgage Lending Has Grown Substantially over the Past Decade

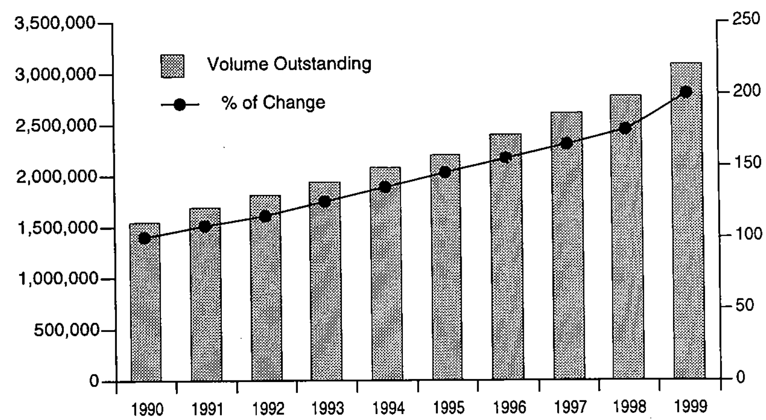
Mortgage lending is a growth industry in Europe. The volume of mortgage loans outstanding in the EU and Norway has increased at a remarkable rate, more than doubling in nominal terms over the period 1989-1999, and amounting to around EUR

3.1 trillion at the end of 1999, which represents approximately 33% of gross domestic product. Mortgage markets, however, retain strong national characteristics and their economic importance varies from one country to another. The largest markets, in terms of volume outstanding, are Germany, the United Kingdom, France and the Netherlands. The markets that have grown most during the period 1988-1998 are Portugal, Spain, Ireland and the Netherlands. Figure 1 illustrates the phenomenal growth of residential mortgage lending over the last decade.

The impressive expansion of European mortgage markets since the late 1980s is the result of a number of factors, of which deregulation in the financial sector and historically low interest rates (as a consequence of preparation for the introduction of the single currency) stand out in particular. This environment has led to intense competition in mortgage markets across Europe and greater affordability of housing, thereby creating favorable conditions for high demand for mortgage loans.

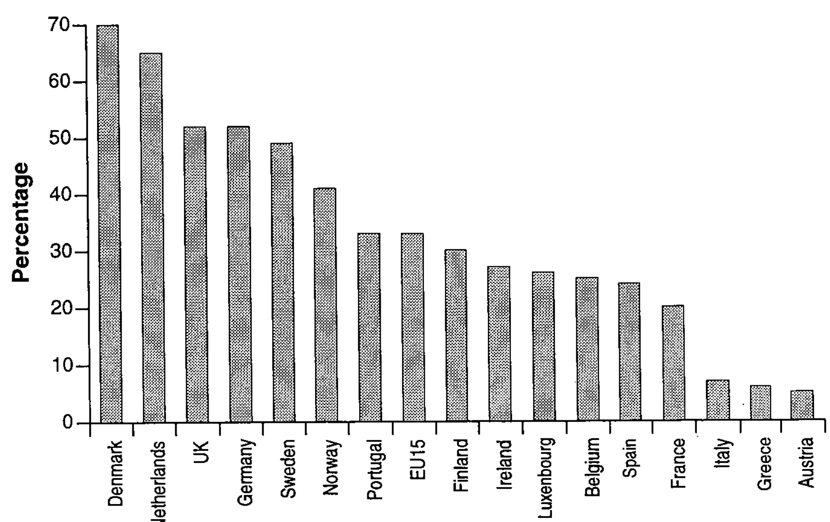
Increased competition, coupled with rapid technological advances, has pushed mortgage lenders to develop new financial products and new methods to market these products to the customer. Product innovation will have to continue to keep up with the needs of increasingly sophisticated and financially astute customers. As the completion of the single currency approaches, euro-denominated mortgage products that can be sold across borders have emerged. The Internet in particular is seen as a very important distribution channel. As more and more customers gain access to the Internet and become comfortable using it, the growth in its use will be very rapid. Indeed, data from Find, the financial services directory, suggests that personal loans and mortgage loans are the most popular subjects on the Internet since they involve an important financial commitment.

Figure 1 Residential Mortgage Loans in the EU and Norway Between 1990 and 1999 (EUR million, volume outstanding, % change)



NOTE: Includes Belgium, Denmark, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, Netherlands, Austria, Portugal, Finland, Sweden, United Kingdom and Norway. Denmark not included in 1990 and 1991. European Mortgage Federation

Figure 2 Size of Mortgage Markets in the Economy (Loans outstanding as a percentage of GDP, end-1998)



Source: European Mortgage Federation and national sources, Eurostat (GDP figures)

European Mortgage Markets Retain Strong National Characteristics

The dynamic growth of mortgage markets has outpaced the growth of GDP over the same period, thereby increasing its weight in the national economies. However, as Figure 2 shows, the importance of mortgage markets differs widely across the different EU Member States. In Denmark, the Netherlands, the United Kingdom and Germany, the volume of residential mortgage loans outstanding is equivalent to 50% of GDP or more, in contrast to other countries such as Italy, Greece and Austria, where it is equivalent to less than 10%.

The large differences in the size of the mortgage markets in the national economy reflect the fact that mortgage markets retain, by and large, strong national characteristics. There are considerable differences across countries due to differences in the types of lenders and, consequently, also differences in the types of products granted such as the duration of mortgage loans, the type of mortgage interest rate and loan-to-value (LTV) ratios. Some of these differences are illustrated in Table 2 and are mostly the result of differences in the political and historical environments and in the legal and regulatory frameworks in which mortgage lenders operate.

The typical maturity of a mortgage loan can vary between 10 years in some southern countries and as much as 30 years in Denmark or Germany (Table 1). Different approaches to consumer regulation can result in only a handful of products offered in some countries, compared to over 4,000 products currently on offer in the United Kingdom. In certain countries, there is a predominance of fixed-rate mortgage products. In other countries, variable rates are more common. In certain countries, the introduction of tight consumer protection rules has resulted in mortgage credit becoming increasingly separated from its sources of funding. For example, complex rules on the variation of mortgage interest in Belgium, which require the change in interest rate to be linked to government bond indices rather than to the true cost of funds for mortgage lending, introduce an interest-rate risk. If interest rates on the loans and funding source diverge, doing business may become uneconomic. Rules, which limit prepayment penalties charged to consumers, also complicate the funding process, and may induce a dangerous situation of mismatching.

The differences across mortgage markets are also the result of differences in the property market (stock of dwellings, housing tenure structure, owner-occupation, private and social rental, financial instruments used to finance the housing sector, etc.) and in the construction industry (number of building permits issued, housing completions, number of transactions, etc.). The general economic situation will also have a direct impact on the mortgage market. When the economy is growing and employment is rising, households increase their demand for housing and for housing finance. Despite economic convergence in Europe, there remain significant differences in the fundamental macroeconomic variables (GDP, unemployment, inflation, etc.) which shape the development of the mortgage markets.

European Mortgage Lenders

Figure 3 shows that mortgage loans are granted by a large variety of different types of mortgage lenders. They range from specialized credit institutions (mortgage banks, building societies, Bausparkassen and other specialist mortgage lenders) to savings banks, mutual and cooperative banks, and universally active commercial banks. European mortgage banks are different from U.S. mortgage companies (which are also called mortgage "banks"). These types of lenders are Monetary Financial Institutions (MFIs) and together they grant more than 90% of the mortgage loans in the EU.[2] The remaining mortgage loans are granted by non-MFIs which include other financial intermediaries (e.g., umbrella companies established to hold securitized mortgage assets through mortgage-backed securities, generally known as special purpose vehicles), insurance corporations and other sectors.

FUNDING OF MORTGAGE LOANS

Retail Deposits

Mortgage lenders in Europe use a large variety of methods to fund the mortgage loans they grant. The method used depends, by and large, on the type of mortgage lender and varies considerably from one country to another. The most common source for mortgage loans in the EU is funds obtained via retail deposits in one form or another (deposits with agreed maturity, deposits redeemable at notice or overnight deposits). The European Mortgage Federation estimates that retail deposits fund 62% of the volume of residential mortgage loans out-

Table 1 Typical Mortgage Products

	United Kingdom	*Denmark*	*Spain*	*France*
Maturity of a Loan	25 years	25–30 years	10–15 years	15 years
Type of Interest Rate	Reviewable	Renegotiable Reviewable	+/- 90% Reference	50% Reference 50% Fixed

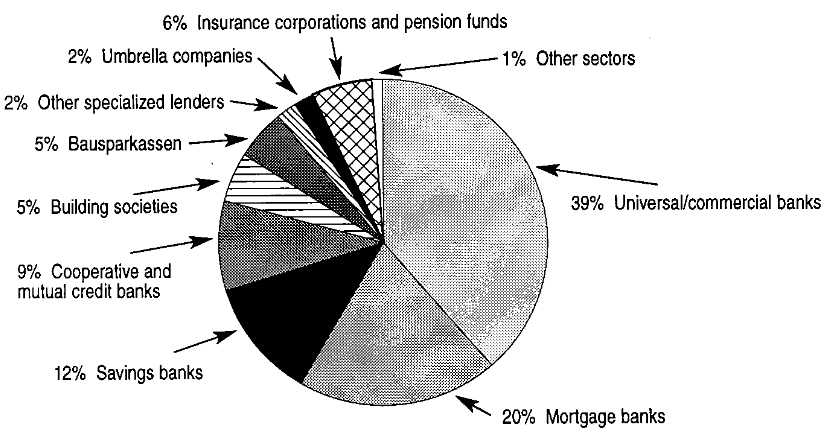
Table 2 Loan Amounts, Maturity and LTV Ratios in European Countries (1999)

Country	*Mortgage Loan (EUR)*	*Original Maturity (years)*	*Loan-to-Value Average*	*Loan-to-Value Absolute maximum*
Denmark	107,000	30	80%	80%
Germany	174,000	25-30	67%	100%
Greece	35,000	15	43%	
Spain	67,500	15	75%	80%
France	80,000	15	67%	
Ireland	92,000	20	61%	95%
Italy	62,000	10	50%	80%
Netherlands	122,000	30	72%	125%
Austria	105,000	25-30	54%	100%
Sweden	136,000	Up to 30	80%	100%
United Kingdom	105,000	25	70%	100%
Norway	108,000		70%	80%

NOTE: Conversion rates for non euro area countries: EUR/DKK = 7.4627; EUR/GRD = 330.300; EUR/SEK = 8.5625; EUR/GBP = 0.6217; EUR/NOK = 8.0765

Source: European Mortgage Federation and national sources © European Mortgage Federation

Figure 3 Market Shares by Type of Institutions, Type of Lender (Percentage based on volume outstanding, end-1998)



NOTE: The category "commercial banks" includes mortgage loans funded by the issuance of mortgage bonds that are granted by the largest "mixed" mortgage bank in Germany.

Source: © European Mortgage Federation

standing. Other "general" funding instruments will include loans from other MFIs (for instance, a parent company) and bank bonds. Mortgage loans will also rely on the own resources (equity capital) of the lending credit institution and insurance premiums (in the case of insurance corporations). Dedicated savings refers to deposits collected through the Bausparkassen system in Germany and Austria. The various funding methods are illustrated in Figure 4. (Retail deposits are covered in more detail in Table 3.)

MORTGAGE BONDS

A mortgage bond is a security giving the holder of the bond a claim against the issuer and enjoying a degree of special security because it is backed by mortgage loans. This additional security significantly reduces the risk to the bondholder and, therefore, he or she will not require as high a return compared to a similar bond that is not backed by mortgage loans. The issuance of mortgage bonds allows lenders to obtain funding at a reduced borrowing cost (relative to unsecured borrowing) in the capital market and it is, therefore, a cost-efficient method of funding a mortgage loan. Figure 5 illustrates how mortgage bonds function to finance housing.

MORTGAGE-BACKED SECURITIES

Typically, the process of production of a new mortgage loan follows three phases: originating of loan, grouping or bundling of loans and funding of loans. Securitization, however, "unbundles" this process. The credit institution creates a legal entity known as a Special Purpose Vehicle (SPV) and sells mortgage loans that it has originated ("receivables") to this SPV. The purpose of the SPV is to isolate the receivables and the associated cash flows from the originator and to perform certain other closely related operations (such as restructuring of cash flows and credit enhancement). The SPV issues

Table 3 Overview of Mortgage Loan Funding Methods by Country (1998)

	Residential Mortgage Loans Outstanding (End-1998 in EUR ban)	Own Resources (Equity)	SPECIALIZED FUNDING		GENERAL FUNDING	
			Mortgage Bonds	MBS	Deposits	Other
Belgium	56	Yes	-	Minor	>50%	Yes
Denmark (a)	122	-	100%	-	-	-
Germany	1013	-	Yes	Yes	Yes	Yes
Greece (a)	7	-	-	-	100%	-
Spain	123	5%	6%	3%	Major	Yes
France	262	Minor	21% (d)	3%	76%	-
Ireland	21	6%	-	0.7%	60%	33%
Italy	81	Yes	-	Yes	Yes	Yes
Netherlands	221	4–8%	7%	Minor	Major	10%
Portugal	32	Yes	Yes	-	Yes	-
Finland	34	Yes	Yes	-	90%	10%
Austria (b) (a)	10	1%	7%	-	38%	54%
Sweden (c)	99	Yes	70%	-	-	30%
United Kingdom	647	-	-	Yes	Yes	Yes
Norway	54	3%	1%	-	48%	48%

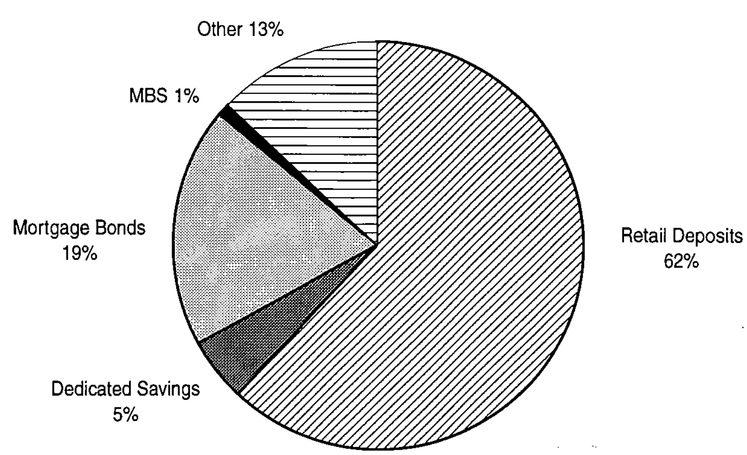
NOTE: (a) European Mortgage Federation members only
(b) Includes commercial mortgage loans outstanding
(c) Refers to housing credit institutions only
(d) of which 4% points bonds issued by CRH

the securities which are sold to investors. (If the originating institution continues to participate, it is usually as "service," i.e., collector of principal and interest payments and processor of other related back-office functions.) This process is illustrated in Figure 6. Figure 7 shows MBS market size for various European nations.

The Bausparkassen System

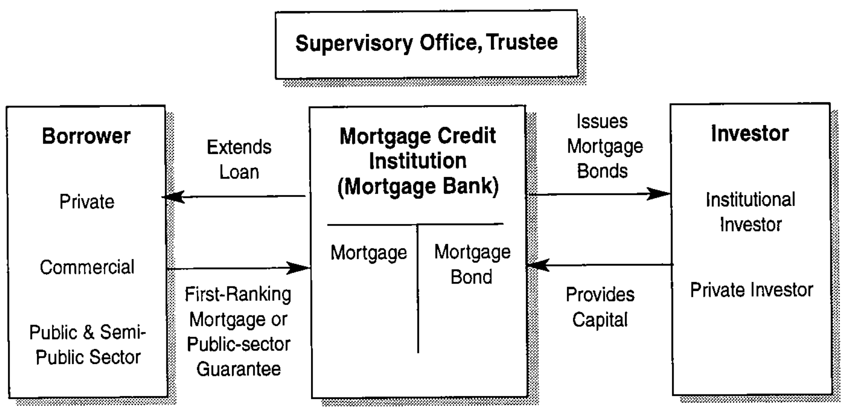
Contract savings for housing (CSH) systems provide housing finance with funding obtained from loan-linked savings deposits. CSH programs may be offered through banking institutions, as in France, or specialized savings and loans institutions, known as *Bausparkassen*, in Austria and Germany. Participants in these systems are

Figure 4 Funding Methods Used in the European Union (Percentages based on volumes outstanding, end-1998)



Source: Estimations based on contribution from EMF national members and own calculations

Figure 5 Mortgage Bonds



Source: Based on Prof. Dr. Klaus Spremann & Dipl.math.oec. Klaus Kränzlein (1996)

eligible for subsidies and/or tax relief from the state upon completion of the savings contract. The participant agrees to save an agreed amount over a prescribed period in return for a commitment on the part of the lender to provide a loan, at pre-specified terms, for the purchase or renovation of owner-occupied housing. The contract typically entitles the saver to a mortgage loan in the future at below market rates. Contract savings programs offered through general depository institutions are open systems as the institutions can draw on other sources of funds to meet the contract loan commitments. *Bausparkassen* are closed systems reflecting the fact that contract loans are funded almost entirely by contract savings deposits.

LIKELY FUTURE DEVELOPMENTS

The current situation of fragmented mortgage and property markets is increasingly subject to external factors of change that should, in the long run, lead to a greater degree of integration.

Deregulation and Consolidation

Until the 1980s, housing finance systems tended to be tightly regulated by national authorities, in particular because of the danger of mismatching in long-term finance but also because many governments wanted to favor access to homeownership at the lowest possible cost.

There were restrictions on the activities of institutions (Italy), balance sheet restrictions (United Kingdom), restrictions of specific mortgage instruments to specific institutions (France and Germany) or regulations of the terms of mortgage contracts (Belgium).

Increasingly, deregulation has removed such restrictions and, in the process, changed the nature of financial institutions offering mortgage credit. In the United Kingdom, many building societies have converted into banks, while in Italy, a new law abolished the principle of specialization and transformed all mortgage lenders into universal banks allowed to engage in all types of banking activity. As a consequence, the type of institution offering mortgage credit is no longer as important as the types of mortgage product which are offered.

As a counterbalance to increased deregulation and liberalisation, regulators and super-regulators such as the UK's Financial Services Authority are increasingly aware of the need for improved supervisory coordination and review in the light of the growth of cross-border financial services conglomerates and the operation of e-banks outside the market for which they have been licensed.

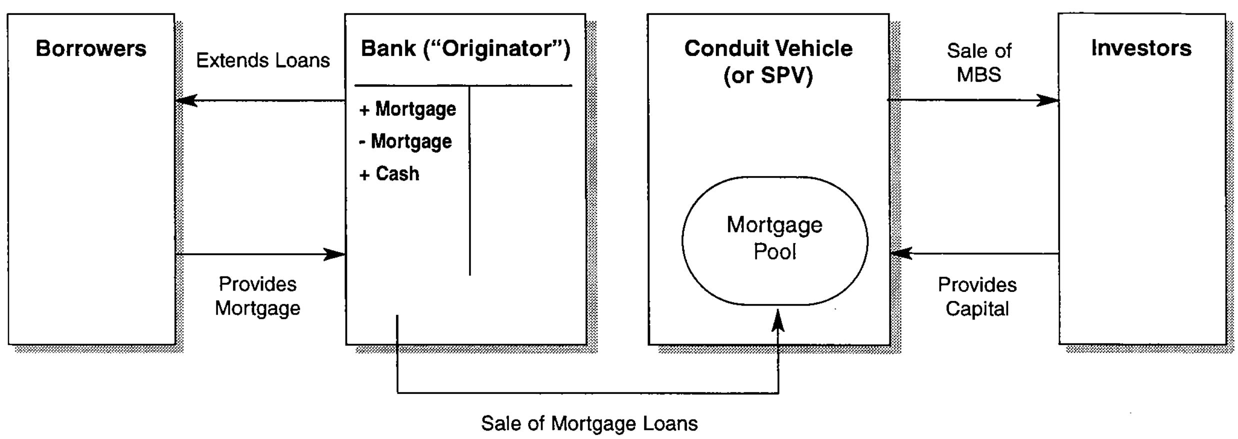
As a measure of consolidation in the EU banking market, the European Central Bank estimated that, in April 2000, the share of bank assets accounted for by the top 20 European banks had risen from 35% in 1997 to 41% in early 1999.

The Internal Market

The internal market program, which was completed in 1992, had a significant impact on mortgage markets across the EU. Markets, which had previously been regulated on a national level, were suddenly subject to EU directives. In particular, the solvency ratio and own funds directives had a significant impact on mortgage credit institutions in Europe.

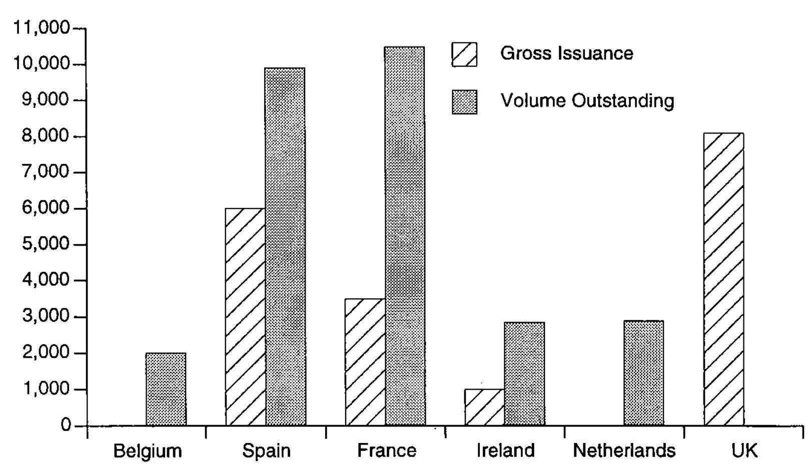
In principle, the single market program should have led to the opening up of national mortgage markets to Europe-wide competition. The principle of home country control should have meant that mortgage lenders would be free to provide services across EU borders, but be regulated by their own national supervisory authorities. In practice, the single market for mortgage credit has not really developed, since governments have not been keen to allow lenders from member states where consumer protection legislation is less strict to compete on an unequal basis with domestic lenders. Furthermore, the absence of tax harmonization has resulted in a number of fiscal obstacles to cross-border mortgage credit.

Figure 6 Mortgage-Backed Securities



Source: Based on Prof. Dr. Klaus Spremann & Dipl.math.oec. Klaus Krânzlein (1996)

Figure 7 European MBS: Market Size and Importance as a Funding Instrument (EUR million, 1999)

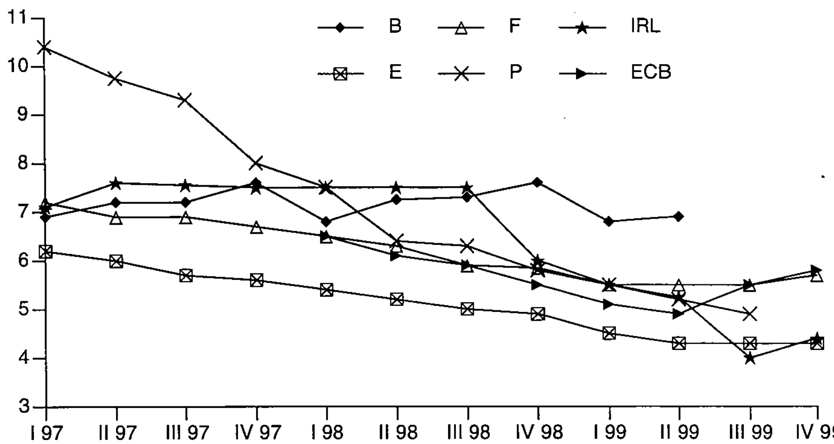


Country	*% Gross Residential Mortgages*	*% Residential Mortgages Outstanding*
Belgium	0%	3%
Spain	14%	6%
France	9%	4%
Ireland	18%	7%
Netherlands	0%	0.7%
U.K.	4%	nav
EU	4%	0.8%

Belgium refers to 1998

Indeed, in its latest progress report on its 1999 Financial Services Action Plan, the focus of the European Commission seems to have shifted from retail to wholesale aspects of financial services. This may be recognition by the Commission of the difficulties inherent in trying to complete an internal market for mortgage credit and that such an objective remains very much an ongoing process—a process that may be assisted by other factors of change such as e-commerce and the introduction of the single currency on January 1, 2002.

Figure 8 Indicative Mortgage Interest Rates in Selected Euro-zone EU Member States



The Single Currency

The introduction of a single currency, more than any other event, is changing the face of mortgage lending in the European Union. The euro will:

- Eliminate exchange rate risks.
- Reduce transaction costs.
- Improve price transparency.
- Reduce interest rate risk through economic policy coordination.

In the "core" countries the single currency has seen maintenance of the environment of low inflation, low interest, long-term views and stability. In the "peripheral" countries, such as Ireland, inflation has re-emerged and low interest rates have created concerns in several countries with respect to asset price inflation including increasing house prices. In the run-up to the launch of the single currency the loss by governments of control over interest rates, as a tool of economic policy, was a concern—the view being that one size does not fit all

The introduction of the single currency has impacted the capital markets and there is now an established euro-denominated bond market, which is less volatile than the earlier national markets. This should favor more long-term instruments such as mortgage bonds and MBS. The policy of governments, as well as the approach of private issuers, is geared towards the creation of as deep, liquid and transparent a capital market as possible. The current nationally based securities markets are being transformed into a single market with common conventions as stock exchanges merge. The reduction of government debt has also left more room for private debt instruments, which had hitherto been crowded out of the market. Finally, the progressive integration of national capital markets into a single supra-national marketplace offers the potential for economies of scale, which had hitherto not been possible in the smaller economies. In particular, this should favor the development of techniques such as securitization.

It is also likely that access to cheap, low-interest long-term funding on the capital markets will favor recourse to fixed-rate funding instruments such as mortgage bonds and MBS, to the detriment of variable rate instruments in the form of savings deposits. Higher-yield instruments increasingly attract savers and this has led to the drying up of the traditional funding instruments of savings and cooperative banks. In addition, mortgage bonds have been included by the European Central Bank in its Tier 1 list of eligible assets for use in open market policy and, as outlined elsewhere in this paper, a number of Member States are working to adapt their mortgage bond legislation in order to ensure that it conforms to the Tier 1 criteria.

Changes on the capital markets are feeding through to the mortgage markets. Indeed, mortgage markets underwent a fundamental change resulting from the convergence of economies in advance of the locking together of the currencies. Interest rates on mortgage loans in the 11 participating countries have converged considerably as Figure 8 shows, and up until recently had fallen to record low levels.

The single currency should lead to greater cross-border opportunities for mortgage lenders, and more competition will benefit consumers. The lack of exchange-rate risk and greater price transparency opens up opportunities for borrowers to take out loans in other member states, and the remaining obstacles to cross-border mortgage lending are becoming more apparent. Considerable efforts are being made by the European Commission to both liberalize and harmonize financial services, which could lead to greater integration of markets.

Finally, such developments may result in change on the property markets. Stable economic conditions should result in greater price stability of housing, while lower interest rates should improve access to owner occupied housing. The loss of national government control over monetary policy may however lead to governments making greater use of fiscal instruments to control the economy, and the property sector risks being particularly affected.

The "E-Economy"

The Internet is playing a decisive role in opening up European mortgage markets as it allows EU-wide market penetration at relatively little cost, i.e., no expensive branch network needs to be established. On-line mortgage lending is currently a growth area with both existing and new players looking to build their share of on-line originations from the initial borrower inquiry through to the granting of a mortgage loan.

In the U.S., more than 15% of new mortgage loans are initiated through the Internet. According to a study by Forrester Research, the American Internet consultants, the U.S. on-line mortgage market is expected to grow from US$18.7 billion to more than US$91 billion in 2003. It further predicts that mortgages will account for more than 10% of the whole on-line market. Almost two-thirds of American lenders expect to be able to process credit applications on line by the end of this year. In more general terms, in April 2000, Datamonitor predicted that the number of Europeans using Internet banking would grow by 30% to more than 20 million users by 2004.

The Internet is, of course, a vehicle for price transparency and more informed consumer choice. Typically, it is at present a source of information for comparison-shopping rather than a means to take out a mortgage loan.

Although e-commerce and the Internet are primarily a distribution means to target borrowers and sell mortgages, they also allow lenders to raise funds from depositors—the jury, however, is still out on the success or suitability of using an Internet bank for the latter purpose. The Internet may become instrumental in the globalization of the capital markets. Already, there is some evidence that housing markets are becoming global and that the single currency is accelerating the integration of property markets in Europe.

Increasingly, EU countries are adopting U.S. mortgage securitization models. This encourages standardization and may create opportunities for American lenders and mortgage technology vendors to expand into these markets. Likewise, it could impact the funding side positively by accelerating the standardization and marketing of the various funding instruments to investors.

The European Commission's directive on certain legal aspects of electronic commerce that was adopted in May 2000 is the first attempt to regulate, at European level, one of the fastest developing fields of the economy. Member States have 18 months to modify their national legislation accordingly.

Indications are that the mortgage industry will initially take advantage of the new information and communications technologies to speed up home buying, accelerate the mortgage process and improve transparency, but it will take some time before cross-border mortgage lending develops fully and benefits from an appropriate legal framework.

Revision of Bank Capital Requirements

The Basel Committee on Banking Supervision and the European Commission are currently reviewing bank capital requirements. The current discussions in Basle and Brussels will lead to a new set of prudential rules that will apply to all credit and financial institutions. The new regulatory own funds requirements are likely to revise the current risk weighting scheme by taking into consideration a broader range of risks (credit and market risks but also operational, legal and reputation risks). Internal rating, market discipline and supervisory related issues are also a focus of both regulators.

The review of regulatory capital requirements is of fundamental importance for mortgage lenders in Europe since the vast majority of their mortgage loans remain on-balance sheet and are capital intensive (i.e., 50% or 100% weightings).

This contrasts with the U.S. system, where more than 50% of mortgage loans are removed from the balance sheet through securitization—thus freeing up the lender's own funds. U.S. government-sponsored enterprises (Ginnie Mae, Fannie Mae and Freddie Mac) buy most of the loans from mortgage lenders and sell them into the secondary mortgage market.[3] In so doing, they convert 50% risk weight assets into 0% (Ginnie Mae) or 20% (Fannie Mae, Freddie Mac) risk-weighted MBS. This creates an incentive for lenders to "swap" their mortgage portfolios for lower-risk-weight MBS portfolios. The GSEs are also not subject to the same own fund requirements as mortgage lenders. Thus, the total capital held against securitized assets is substantially less in the U.S. than in Europe.[4] These powerful agencies also benefit from government support that reduces their funding costs by as much as 50 basis points. The existence of these agencies is a major reason for the high percentage of loans securitized in the U.S.

Europe's secondary mortgage markets mirror the diversity and the history of primary mortgage markets. Mortgage bonds issued by specialized mortgage banks and credit institutions have been a major funding instrument in several countries for more than 100 years. Mortgage banks, as portfolio lenders, fund their mortgage assets through the issue of mortgage bonds and have to rely solely on their financial strength and strict regulations to ensure the soundness of their mortgage bonds. Mortgage-backed securities issuers rely on the quality of the collateral and various structuring techniques to create high quality securities. In Europe, there is competition between on-balance and off-balance sheet instruments on the basis of the intrinsic quality of the issuing institution and the securities issued. The emergence and standardization of mortgage financing instruments should be encouraged as European lenders use a wide variety of methods from mortgage bonds to securitization to fund their mortgage loans.

The current proposals, influenced by the American off-balance sheet approach, could put European mortgage lenders at a disadvantage. In particular, current proposals that would accord a lower risk weight (20%) for highly-rated mortgage securities could create opportunities for capital arbitrage and could put portfolio lenders at a competitive disadvantage as it would be less capital intensive to buy mortgage- and asset-backed securities than to have a mortgage book. The vast majority of mortgage loans in Europe (over 98%) remain on the banks' balance sheets and are capital intensive (i.e., 50% or 100% weighting).

Apparently, there is agreement on the part of the regulators to maintain the current regulatory treatment (i.e., 10% weighting) of mortgage bonds according to Article 11 (2) of Directive 89/647/EEC on the Solvency Ratio. The European Mortgage Federation believes that the weighting of mortgage-backed securities should relate to the credit risk and there should be no supervisory discrimination between instruments other than on the basis of a comparison of credit quality.

CONCLUSION

European primary mortgage markets have been growing more quickly than GDP and have proved surprisingly resistant to change, even though both mortgage and property markets are tightly governed by national law. Differences in tax and subsidy rules, consumer protection rules and the fact that mortgage lending has always been considered as a local business with various ways of providing mortgage credit, will mean that the achievement of a single European market in the field of mortgage credit can only take place in the longer term.

However, these structural differences are increasingly subject to the factors of change, which strive to impose a certain level of integration.

Following the introduction of the single currency, all indications are that we are moving towards a European capital market with the funding of house purchase being an integral part of that market via funding instruments ranging from mortgage bonds to mortgage-backed securities. Savings or retail deposits remain the most common way to access funds for lending purposes; but in the low-interest-rate environment existing up until recently, they have become increasingly subject to competition.

Mortgage bonds, the second most popular source of funds, and mortgage-backed securities, both specialist mortgage instruments, are proving particularly attractive in this new environment. The development of a single capital market has led to new opportunities for the wholesale funding of mortgages, resulting in new products on the primary markets.

Legislative progress in the creation of a single market for the provision of mortgage credit has been painstakingly slow. On the other hand, one has to be optimistic about the likely impact of the business drivers of changes such as the Internet and the single currency on a macro level and cross-border commercial property lending on a micro level.

The current review of bank capital requirements being undertaken by the Basel Committee and the European Commission will influence the business environment faced by mortgage lenders for, at least, the next 15 years. Therefore, how funding instruments are treated is of crucial importance for lenders in both the European Union and the accession countries.

NOTES

1 The European Mortgage Federation, based in Brussels, is the leading organization representing mortgage lenders in Europe. Its members are mortgage banks, savings banks, building societies and insurance companies. Together, they grant over 70% of mortgage loans (residential and commercial) in Europe.

2 In 1997, the European Mortgage Federation classified the different types of mortgage lenders according to the ESA95 framework. ESA95 is the European System of national and regional Accounts 1995 which

was introduced by a Council Regulation of June 25, 1996. It provides a methodology for common standards, definitions, nomenclatures and accounting rules, intended to be used for compiling accounts and tables to be drawn up on comparable bases for the purposes of the Community. The Regulation is binding in its entirety and directly applicable in all Member States. Mortgage lenders are classified as follows: (i) **Monetary Financial Institutions (MFI)** includes universal/commercial banks ("commercial banks"), mortgage banks/mortgage credit institutions ("mortgage banks"), savings banks, mutual and co-operative banks, building societies, Bausparkassen, other specialized mortgage lenders; (ii) **other financial intermediaries** (with the exclusion of insurance companies and pension funds) refers to umbrella companies established to hold securitized mortgage assets through mortgage-backed securities, generally known as special purpose vehicle; (iii) **insurance companies and pension funds** refers to insurance companies; and (iv) **other sectors.**

[3] Ginnie Mae is an agency of the U.S. government and its securities benefit from a full faith and credit guarantee. Fannie Mae and Freddie Mac are government-sponsored enterprises (GSEs) that are owned by the public and benefit from certain charter advantages. They issue corporate guarantees which are widely viewed as being implicitly backed by the government.

[4] For example 2% against a Fannie Mae MBS (1.6% by the lender and 0.4% by Fannie Mae) as compared to 4.8% for loans funded by mortgage bonds in Europe (4% by the mortgage bank and 0.8% by the mortgage bond investor).