Experience in Cross-Border Residential Mortgage Lending in the EU: Examples from Portugal and Greece

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In the past years, some mortgage lenders have started to develop their businesses in other European markets, trying to get the most of the convergence in the European Union of 15 economies (25 from 2004 onwards) and of the launch of the Euro zone (11 economies).

While these initiatives are rather common in the commercial mortgage sector, they remain very seldom in the residential mortgage business, for a series of obstacles such as, amongst others, difficult access to a distribution network, incompatible consumer protection laws, and strong national differences in housing finance systems.

Earlier in 2003, the European Commission together with the European Mortgage Federation has set up the Forum Group to study these main obstacles and to formulate in 2004 political recommendations to the European Commission on the most appropriate ways to achieve an integrated market for home loans.

In the meantime, in the European mortgage lending community, cross-border financing is commonly considered as the key indicator of market integration, the more integrated the markets, the easier the financing across borders.

Nevertheless, like Nessie, the famous Loch Ness dweller, everybody speaks about cross-border residential mortgage financing but nobody has really seen anything.

It is the purpose of this article to stress that cross-border residential mortgage lending already exists in practice, although to a limited extent, and to highlight, as a matter of example while the Forum Group reaches its conclusion stage on a much broader basis, some of the difficulties and obstacles UCI experienced when entering the Portuguese and Greek mortgage markets on a cross-border basis.

1 - UCI's background:

Union de Creditos Inmobiliarios (UCI) is a Spanish credit institution created in 1989 as a joint venture company between the two banking groups, Compagnie Bancaire of France and Banco Santander of Spain.

After several mergers in the 90's, both initial shareholders have been integrated within larger groups, now the BNP Paribas and the Santander Central Hispano banking groups, which makes UCI's tour-de-table one of the most prestigious in the European banking arena.

UCI is a non-deposit taking mortgage lender, specialising in residential mortgages, and has covered Spain since 1989, Portugal (branch) since 1998 and Greece (branch) since 2003.

By end 2002, UCI's financial highlights were the following: Euro 5 billion of loans under management, 25% after-tax ROE, 10.25% BIS capital ratio, 45% cost/income ratio, a staff of 550 and, in 2003, originations will exceed Euro 2 billion of new residential loans.

UCI's commercial strategy is focused on distributing cost-efficiently through channels of intermediaries, principally real estate agents, innovative mortgage products with a top quality service and a sophisticated credit-risk control.

UCI manages the whole of the loan process, from origination, underwriting, closing, funding, servicing, recovery, to foreclosing and property management.

The servicing of the loans is provided in-house on a flexible and parameterised platform, which allows a streamlined process, using work flow management, on-line application, automated decision, electronic delivery of documents, digitalised documentation, etc, with state-of-the-art technology.

The funding is provided either by UCI's shareholders (credit lines and asset liability management) or by securitisation (50% of UCI's outstandings have been securitised in 9 deals since 1994).

Beside its lending activity, UCI has recently started to develop two other related service businesses: firstly, Real Estate Services, through Comprarcasa, the largest network of real estate agents in Spain, a company created in 2001 with several associations of real estate agents and controlled by UCI, and secondly, Mortgage Services, which consists in the origination, underwriting and administration of mortgage loans for third parties, and in the back-up servicing in secondary mortgage markets.

BNP Paribas also owns 100% of another specialised mortgage lender, Union de Credit pour le Batiment, (UCB), created in 1953 in France, which has had subsidiaries in Italy since 1989 (Banca UCB), and in the Netherlands since 2003 (UCB Hypotheken).

2 - Cross-border residential mortgage lending in the EU:

These financial transactions have been enabled by the creation of the single European passport in 1992.

According to the 2nd Banking Directive, the development of a financial business within the EU can be carried-out in 3 ways: the set-up of a subsidiary, the set-up of a branch, or the set-up of a free financial services provision.

As a preliminary remark, the set-up by a EU financial institution of a fully fledged subsidiary cannot be considered as cross-border financing, since the subsidiary company, itself a local financial institution with share capital, is supervised by the local regulators and should comply with the local legal environment.

Hence, today, cross-border financing can be achieved:

a - on a long term basis, through the set-up of a branch abroad, which by definition has no separate legal identity but is a mere extension of the financial institution existing in its home state, and does not require to invest any share capital in the host country,

b - on a short term basis, for the lack of control it implies, through the free provision of financial services from the home state (i.e., without branch or subsidiary), by outsourcing the operational aspects of the business and using local servicing companies, an already established distribution network and home country funding.

Therefore, the tools and means exist and have been available at least for a decade but, as mentioned before, residential mortgage lending, from one EU member state to another, is rather uncommon, because its development encounters three main impediments:

- Firstly, the difficulties of access to and control of a distribution network in the host country is a key factor to the development and profitability of any mortgage business:

Today, in order to market residential mortgage products and reach end consumers in another country, a financial institution cannot rely only on the Internet to successfully tap a mass market and therefore, needs to sell its products through a local distribution channel, e.g. a network of branches or of intermediaries, either by acquiring it, creating it from scratch or renting it and requires a costly investment which would most probably only yield a return in the medium/long run.

- Secondly, the legislations on consumer protection are not harmonised in the EU:

The 1987 Consumer Credit Directive and the 2001 Code of Conduct for Home Loans introduced standards in terms of borrower protection and a minimum harmonisation across member states, but there is no true single market yet, as each market has its national rules and can impose more stringent legislation to foreign lenders.

- Thirdly and more importantly, even though the EU economies are progressively integrating, the mortgage markets of the member states retain strong national characteristics. Considerable differences across countries, due to the variety of housing finance systems, create a unique environment of hurdles and even threats to the Pan European development of mortgage lending.

This is contrary to the commercial mortgage sector, where cross-border financing opportunities are more frequent: The potential customers abroad are mostly large international corporations that do not require locally a specific distribution network, the consumer protection is less regulated and, furthermore, the home country jurisdiction can usually be applied.

3 - Difficulties a specialised residential mortgage lender is confronted with when entering other markets through the single European passport:

Apart from the commercial difficulties, principally related to the language, the distribution network and the credit risk policies, which are naturally to be expected when launching any financial business anywhere, a long list of other hurdles had to be tackled beforehand in order to get a branch abroad ready to initiate a mortgage business:

3.1 - Access to the relevant information

First of all, in order to undertake a precise market study, the quality of the market data is paramount, and beside language considerations, in the EU it could still be rather complicated to obtain access to exhaustive and accurate data (e.g. Greece).

Good macroeconomic statistics are often easy to obtain from the Central Bank or Ministry of Finance, but on the contrary, in-depth data on the mortgage market, such as volume of mortgage outstanding by categories or new production, are scarce.

Also, very limited historical loan performance data is usually available, neither it is easy to have sufficient detail on house prices.

3.2 - Recognition of the mother company

The single passport is usually obtained in two to three months from the Central Bank of the home country (in UCI's case, Bank of Spain) and within a few more months the Central Bank of the host country can give its approval.

However, the classification by Central Banks of financial institutions operating under their supervisions is not harmonised across EU countries, and the by-laws of an institution cannot be transposed identically from one country to another.

Activities of a financial institution in its home market may not be allowed as such in the host country, e.g. leasing or housing finance activities may sometimes be required to be carried-out through ad-hoc entities which requires creating local subsidiaries with share capital, out of the single passport framework.

Moreover, mortgage loans in some EU countries can only be distributed by banks, which may limit the possibility to start a particular activity in another country if the home country institution is not a bank.

This generates uncertainties related to the category in which the host country Central Bank classifies the new entrant and as a consequence, to the type of business allowed.

As a matter of fact, in the case of Greece, the UCI branch belongs to the category of banks, when the company is not specifically a bank according to Spanish classification.

3.3 - Distribution of loans subsidised by the state

It is most likely that a financial institution specialising in mortgage loans would contemplate at one point in its development the possibility to distribute subsidised loans through its network, especially in markets like Portugal, where up to 2002, 40% of the new loan production was in this market segment.

A special authorisation by Supervisory entities, such as the Central Bank, the Treasury or Ministry of Finance, etc, is usually a pre-requisite to develop such an activity and would most probably only be granted if the branch complies with high standards of professionalism and financial guaranties.

However, this authorisation could sometimes be expected for months, when for example local Parliaments need to pass a specific amendment to existing regulations in order to allow non-bank financial institutions to operate within this mortgage sector.

Also, the privilege to offer (e.g. Greece) special housing saving schemes giving the right to the account holder for obtaining subsidised loans (up to 150% of the account balance), recently extended, is however not applicable to non-banks.

3.4 - Access to private and public credit risk data bases.

The access to credit data bases in the host country on a cross-border basis is essential as it is the only means for a lender to get information from either public or private sources on the creditworthiness of the prospective borrowers.

Some host countries give access to public credit registers (sometimes controlled by the Central Bank) only if the new entrant has locally a branch or even a subsidiary, which is a definitive impediment to the development of a free provision of services across borders.

Other countries like Greece have private registers which require previous membership to get access to the credit histories.

One key aspect is that, regardless of the quality of information and for customer protection purposes, the data base administrator obliges the prospective lender to keep in its archives the original copy of the authorisation, duly signed, given by the prospective borrower to consult its personal credit history.

The full respect of the procedures related to the credit data base is made compulsory and is subject to periodical audit and enforcement by the Supervision authorities, which could lead to a ban in case of repetitive misuse by the financial institution.

3.5 - Property appraisals

Obviously, when studying the possibility of entering new markets, the quality of collateral taken by the mortgage lender is a key determinant of its future risk, as well as the access and reliability of the information given by the appraisers.

Some countries (e.g. the UK) have data bases of properties that allow online access to past valuations, however in most of them, the information is not available and requires a specific visit by an appraiser of the property to be mortgaged.

Across the EU, the methods used by property appraisers are fairly similar (comparative method, replacement cost method, exploitation method, or discounted rental method) but they are often subject to regulations, either through consumer protection laws or Central Bank supervision policies.[1]

To highlight the discrepancies between countries, a few examples follow:

In some countries, valuation is not compulsory (e.g. France), in some others (e.g. Spain), laws have been passed to regulate the valuation methodology, the qualification of appraisers and the information given to the consumer. In another group of countries (e.g. Greece), the property valuation is statutory although no law regulates its format, and some imported best practices (like the RISC methodology)

[1] With the exploitation method, the evaluator is working out the best possible development scenario for the property under valuation, using data and information that arise from the study of the available data, the site visit and the information. Then, he approximates the revenues from the sale of the to be developed property and the costs of the development. The value of the property, in the present phase, derives by subtracting the costs from the revenues. When the valuation concerns not constructed land, the value arising from this method is the value of the land after development. The initial value of land results by applying the appropriate mathematical function (cash, before development).

are commonly used by both lenders and appraisers.

Furthermore, in some EU countries like Spain, for the relevance of collateral valuation on the risk of mortgage portfolios and consequently on solvency ratios of financial institutions and on securitisation, the Central Bank periodically carries out an assessment of the independence and rigor in methodology of the appraisal companies.

Thus, when opening a branch abroad, the alternative for a Spanish financial institution is twofold:

Either the valuation method used by the local appraisal company strictly respects the guidelines authorised by Bank of Spain, even though it is not common practice in the host country,
or this will considerably impact both the levels of banking provisions and capital required by the Bank of Spain on the activity generated by the branch and the possibility to later pool these loans for securitisation purposes.

It is foreseeable, with the efforts dedicated to persuasion and training of local appraisers that the time and finally the costs involved in such a process could be very significant.

3.6 - Bank provisions

The provisions for credit risk are not yet harmonised across the EU, which provokes a relative distortion of competition between local and foreign entities, at least until two conditions are met:

- the instalment in 2005 of the new IAS accounting criteria
- the future Pillar II of the Basle II agreement does not introduce too much bias between countries.

Following the European single passport, a branch in the EU is supervised by the home country Central Bank and must comply in the host country, on a consolidated basis, with level of provisions imposed in the home country.

When the provisions for credit risk are more stringent than the ones imposed by the host country's Central Bank to local financial institutions, (e.g. nowadays, the generic provision of 0.5% on performing mortgage loans imposed by Bank of Spain), the pricing and hence the competitive positioning of the branch is affected negatively.

3.7 - Capital requirements

The financial institutions in the EU, under the supervision of the BIS, should comply with the Basel I (and soon the Basel II) criteria on international capital adequacy, according to which in 2003 a residential mortgage loan requires a risk-weight of 50%.

However, in some EU countries such as Spain, a more stringent national mortgage directive applies, at least until the new IAS accounting criteria and the "fair value" concept are put in place, which, amongst others, grants a risk-weight of 100% to any residential mortgage loan if the Loan-to-Value ratio is greater than 80%.

The branch in the host country has no specific capital requirement but on a consolidated basis, for any loan granted by the branch abroad, the Spanish financial institution should comply with the Spanish standards on capital adequacy.

As a consequence, the pricing strategy at the branch level should take into account the enhanced capital requirements imposed by the home country Supervisor in order to match the profitability objectives on a corporate level.

This again could affect the market positioning of the branch and lead to unfair competition in the host country.

3.8 - Tax aspects

The progressive integration of economies has not yet reached in depth the tax systems across the EU and this explains the huge differences in concepts, values, and subsidies encountered.

The purchase of a house, the closing of a loan contract, the constitution and registration of a mortgage and the foreclosure procedure are all submitted to taxes which differ widely between member states and, to some extent, a financial institution interested in developing its activity abroad should be prepared to parameterise its workflows and accounting accordingly.

Also with respect to withholding tax, there are still some unfair rules remaining for foreign entities (e.g. Greece) which generate higher costs.

3.9 - Labour costs

The EU has triggered a steady integration of 15 economies. However, some aspects have purposely been lagging behind, for example the labour policies.

Beyond any considerations about local remuneration levels, tax system and productivity of employees, the classification by the local Central Bank of the branch is not neutral on the labour costs, since this could lead to differences in the employee work convention and status between countries, even though the company is legally the same.

Also, as banking hours differ across conventions and countries, it could hinder the efficiency of the branch compared to the company in the home state, by forcing local employees to work on extra time to deliver locally to particular customers exactly the same service as in the home country.

3.10 - Consumer protection

In all member countries, the consumer is protected by national and European legislation and there exist the possibility that on some aspects, the national law is more stringent than the European standard.
With respect to UCI, the branches abroad follow both the host countries' national consumer protection laws and the European Code of Conduct for home loans.

In countries where the prepayment fees are limited by law, the market (and UCI) has predominantly developed variable rate mortgage products to avoid or limit the prepayment risk.

3.11 - Underwriting procedures

A very detailed study was undertaken by the European Mortgage Federation in 2002 on the efficiency of the mortgage collateral, with a particular emphasis on the aspects of constitution, registration, ranking, repossession of mortgage loans across the EU.

Although the national systems in which UCI operates appear to be secure and efficient on a general basis, very strong peculiarities exist as expected in each of them.

In practice, the difficulties encountered consist in taking into account these particularities in the workflows and in being ready to manage, for example, the following differences:

- The mortgage is taken in a land register in Spain and Portugal and in a deed register in Greece, none of them being accessible on-line.
- Intervention of the notary in Spain and Portugal, whereas in Greece the loan contract is a private contract.
- In Greece, the borrower (and the house seller) are very often accompanied by their own lawyers.
- The constitution of the mortgage is authorised by a court in Greece and by a notary in Spain and Portugal
- In Portugal, a provisional mortgage is taken before the closing, whereas in Spain, the mortgage is taken only after the closing. On the contrary, in Greece, for tax reasons, the usual procedure is to take only a prenotation of mortgage, the true mortgage is taken only when foreclosing the loan.
- The inherent taxes are paid to the tax authorities before the closing in Portugal and Greece where as in Spain this step takes place afterwards, possibly with the loan proceeds.
- Any previous mortgage is economically cancelled before closing in Portugal and Greece, whereas in Spain this procedure takes place after the closing.
- The principal amount is paid to the borrower at the notary in Spain and Portugal and only after registration in Greece.
- The Portuguese land register is not accessible on a cross-border basis.
- And obviously, each country has its own tables of constitution and registration costs.

3.12 - Foreclosure procedures

In the EU, the actual legislations and codes are a result of interactions between the Roman law, Common law and Ottoman law, etc. It is thus not surprising that the enforcement of sureties differs across countries, either in terms of procedures or of duration and cost.

The differences are significant, from the measures to be taken before starting the foreclosure, the execution, the Exequatur, the possession, the publicity, the appeal possibilities of the debtor, to the sale of the guaranty.

The length of whole process, from the start of the enforcement procedure till the reception of the proceeds after auction, can vary from 1.5 year in Spain to 3 years in Greece and Portugal.

Their impact on the risk and profitability of the business is paramount and requires careful analysis before any launch abroad.

3.13 - Access to local outsourcing companies

As the European mortgage markets are not yet unbundled, the mortgage lenders usually keep the management of the whole mortgage process in-house.

Consequently, it is very difficult or almost impossible, to find in the host country independent outsourcing companies ready to administrate part of the value chain for third parties and, therefore, the new entrant should be prepared to manage the entire business and deliver the services in-house.

This requires a strong investment in IT system adaptation, development and maintenance, areas where economies of scale are not necessarily easy to achieve.

4 - Conclusion

In the end, faced with such obstacles, what interest remains in developing such cross-border operations?

Can a business match its market share and profitability objectives in these conditions?

If a new dynamics of market integration is not triggered by the Forum Group's recommendations, it is possible that very few cross-border operations will be carried-out with the necessary return on investment.

However, our conviction at UCI is that this cross-border financing strategy is worthwhile from a business standpoint if, in the host country, the branch:

- brings value to the local mortgage market (new channels and innovative products, better service, enhanced competition ...),
- can rapidly reach the adequate market share,
- gets in the short/medium term the adequate return on investment and,
- generates economies of scale at the group level.

This last pre-requisite is of utmost importance, beside any consideration of access to a distribution channel, new business generated and profitability.

A financial institution interested in cross-border residential mortgage financing in the EU should beforehand have developed a business model which, when expanding abroad, allows for gains in overall efficiency and productivity and permits the amortization of fixed costs and future investments over a larger number of loans.

As a conclusion, the paradigm of such a mortgage lender consists in being able to sufficiently integrate its foreign branch network within the home company teams, with regards to a common business culture, marketing strategy, similar product range, country specific streamlined processes on a Pan European IT platform, while keeping the local characteristics of each national markets.

Not that easy to achieve and the challenges that lie ahead are still considerable...