les Acteurs Français
du Droit à L'International
The Continental Law Professions
International Initiative

CONSEIL SUPÉRIEUR
DU NOTARIAT

Continental Law and the Global Financial Crisis

World Bank, Washington, DC

Monday, May 11, 2009

Round table 1

<u>HOW TO BEST REDUCE RISKS ON THE MORTGAGE MARKET</u>

WHY SOME FORM OF REGULATION IS REQUIRED

(Note: This presentation focuses on mortgage loans granted to individuals purchasing residential property).

- Answer : So as to avoid
  - First and foremost, excessive risk taking in the granting of mortgages, and
  - Further purchases/sales of such mortgages on the mortgage market.

- The regulation on mortgage granting is essentially local/national (there is little demand for international mortgages).

- By way of example:
  - Stringent regulation is currently already in existence and practiced in <u>France</u> and has been for a while.

- The French legal system has
  - developed rules limiting mortgage loan granting and
  - provided the banker and legal counsel (ie. French civil law notary - *notaire*) with a central role.

- Mortgages granted in France are generally considered "reasonable" from a risk standpoint.

INDENTIFYING REASONABLE MORTGAGE RISKS

- Mortgages granted in France may be considered as "reasonable" for the following reasons:

  - The lending bank will generally lend up to a maximum of 70/80% of the value of the property being purchased (ie. minimum 20-30% equity).

    - As opposed to 100/110% of the value of the said property in other countries.

- The bank will almost systematically require a charge over the property (ie. mortgage) so as to recoup ownership of the asset in case of foreclosure.

  - As opposed to countries where increasingly fewer guarantees have been required from the borrower.

- The lender will generally have a claim not only over the mortgaged property but also over <u>all the borrower's assets</u>, if need be.
  - As opposed to other countries where the bank only has a claim over the property mortgaged (ie. "non recourse loans").

- The interest rate applied by the bank will most of the time be a fixed interest rate and, if at all variable, the said interest rate variation will be allowed but within a narrow band (high and low). For this reason, the borrower's debt will only increase or potentially increase within fixed limits.

  - As opposed to other countries:
    - In which the initial 110% loaned amount can rise to 120/130% of the property value with a variable interest rate;
    - Whilst the property is at risk of losing value;
    - Thereby eventually creating a considerable gap (sometimes 60%) between the property value and amount loaned;
    - The residential owner then abandons the property (foreclosure procedure) since he is not liable over any of his other assets.

- The lending entity will thoroughly study the future borrower's creditworthiness and such study will comprise a full analysis of all his income and assets.

  - As opposed to other countries in which little or no verification is made as to the borrower's income, assets or credit history.

- Since the loan does not generally cover 100% of the property value, the bank will require from the borrower a reasonable downpayment from personal funds (ie. equity) and/or a complementary guarantee such as a personal charge. If no additional guarantee is requested by the bank, the purchaser may be considered creditworthy.

- The lending entity will check that the borrower is in good health via a medical exam and even where he is in good health, the bank will request from the borrower that he subscribe to insurance in case of death or invalidity.

- The bank will only accept first rank mortgages without any other first rank competing lender and sometimes even with a ban on 2nd rank mortgages.

- The French civil law *notaire* (ie. legal counsel), mandatory on all real estate transactions in France, will effectuate a title search so as to ensure rightful ownership over at least 30 years. By doing so, the *notaire* will guarantee the validity of the mortgage. The *notaire*'s insurance will kick in if ownership is brought into question. Additionally, the responsibility on such ownership and validity of mortgage issues is joint and several amongst all French *notaires*.

  - Downside to the French legal system: Costly and lengthy transactions.

  - As opposed to other countries where the *notaire* does not actually exist, the presence of legal counsel being occasional and the use of title insurance widespread. Such title insurance comes at a cost and does not provide the same ownership/mortgage guarantees.

- The *notaire* will register the mortgage for the duration of the loan plus an additional year. Also, the mortgaged amount will correspond to the loan amount as well as interest and accessories (ie. litigation fees, penalties and complementary interest). The bank can therefore recoup not only the capital, but also interest and accessories.

  - Downside to the French legal system: Lengthy and expensive procedure.

- The *notaire* will deliver to the lending entity an enforceable copy (ie. *copie exécutoire*) of the mortgage agreement. This copy has a value identical to that of a court judgment (ie. executory). In case of default by the borrower, the banks' rights as set out in the mortgage agreement can therefore be immediately executed by the bank, without any further intervention from the courts.

  - Downside to the French legal system: lengthy procedure.

  - As opposed to other countries in which such enforceable copies do not exist and a court decision is required for the bank to be able to foreclose on the property.

IDENTIFYING REASONABLE RISK MORTGAGE PACKAGES

- When mortgage packages are released onto to the mortgage market, the purchaser does not always have a clear picture as to whether his investment risk is reasonable or not .

- Indeed, identifying reasonable risk mortgages proves to be difficult.

- Therefore, regulation on the eligibility of mortgages on the mortgage market needs to be demanding as well.

- France has enacted regulatory provisions on the matter (not to be detailed in this presentation).

WHAT KIND OF REGULATION TO IMPLEMENT

- The answer this question is not straightforward.

  - The common belief is that the current financial crisis is due to excessive liberalism and a lack of control/regulation by the State.

  - When the root cause of the downturn should be analyzed as a crisis in regulatory ideology within a very specific context, the <u>US housing market</u>.

- The deficiencies therefore do not lie in a lack of regulation but more in the evasion of some of the existing or newly created rules, mostly for political reasons, and excessive State intervention.

  - The political context: encourages US credit institutions to lend to less privileged citizens so as to allow them to access the property market (and gain favourable votes). Loans in the US have been used as a substitute for income.

- Such policies and regulations to implement them have not been a focus point in France or at least not to the same extent.

- With housing prices going down, the whole system collapsed and spread worldwide,

    - the above-mentioned unreasonable risk mortgages having circulated throughout the international mortgage market.

- In addition to deficiencies in local or national rules, as previously discussed, the Basle accords also played an active role in the crisis.

    - By requiring banks to keep a minimum 8% equity (ratio) within their commitments and thereby forcing such banks to either reduce their loan granting (and profits) or raise their equity.

    - By pushing credit institutions into a whole new business: securitization, so as to get around the Basle regulations.

    - The Basle ratios were to be used as an alarm system by anticipating bank defaults. The outcome was quite the opposite since these Basle rules only emphasized the financial meltdown.

- Conclusion:

    - The regulatory response needs to take into account numerous, complex and intricate elements such as,

        - local/national and international regulations;
        - public policies and interventions.

    - The main factor to keep in mind is the need to reinforce and maintain the liquidity of the banking market, which has been called into question by the very unreliable nature of the investments made and currently is below reasonable levels.

    - The solution to the crisis perhaps lies,

        - neither in questioning globalisation and capitalism,
        - nor in a return to massive State intervention and regulation of economic and financial activities,
        - but rather in a critical exam of the series of public interventions over time.

    - Capitalism is not the issue but overregulation may well be.

Silke Rochelois

French Civil Law Notary - *Notaire* - Partner
Former New York practicing attorney
Admitted to the New York and Paris Bars