

**CONTINENTAL LAW AND THE GLOBAL FINANCIAL CRISIS
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**Improving Consumer protection and Risk management
Framing Creditworthiness for Homebuyers**

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**1. THE NEW EUROPEAN LEGAL FRAMEWORK FOR
CONSUMER CREDIT (DIRECTIVE 2008/48/EC OF 23 APRIL
2008 ON CREDIT AGREEMENTS FOR CONSUMERS)**

The 2008 directive is to be transposed and applied by Member States from 12 May 2010.

1.1 THE SCOPE OF THE DIRECTIVE

The principle remains that all credit agreements for consumers are covered by the Directive, subject to a certain number of exceptions.

Compared to the previous directive 87/102/EEC these exceptions are restricted. Particularly as far as the amount of credit is concerned, the ceiling of application of the Directive has been raised from EUR 21 500 to EUR 75 000. Credit agreements with a repayment period not exceeding three months are included in the scope of the directive, unless insignificant charges are required. A specific exception is provided for all overdraft facilities where the credit has to be repaid within one month.

As to mortgage credit two changes have been introduced.

On one hand, credit agreements secured by a mortgage or by another comparable security commonly used in a Member State are henceforth excluded, irrespective of their purpose.

The purpose of the loan is still taken into account. In this respect credit agreements the purpose of which is to acquire or retain property rights in land or in an existing or projected building are excluded as previously.

On the other hand, credits financing renovation or improvement of an existing building are not excluded anymore unless, of course, their amount is above EUR 75 000.

1.2 A FULL TARGETED HARMONISATION

The principle of a full targeted harmonization has been adopted:

- ▶ full : means that Member States are not allowed to maintain or introduce national provisions other than those laid down in the Directive,
- ▶ targeted: such a harmonization applies only to some aspects of the credit agreement regime that are deemed crucial.

1.3 THE CREDIT AGREEMENT REGIME

1.3.1 Pre-contractual information

The advertising shall encompass standard information when it indicates an interest rate or any figures relating to the cost of the credit (except in a case of a stand alone APRC). Different pieces of information shall be given (borrowing rate, total amount of the credit, APRC ...) through a representative example.

Once the lender and the borrower have made contact, in good time before the latter is bound by any credit agreement or offer, the lender must provide him with pre-contractual information under the form of a Standard European Consumer Credit Information (SECCI). This document includes a long list which covers almost all contractual elements which will be mentioned in the credit agreement (characteristics of the credit, APRC ...).

Less information is required for overdraft facilities and certain specific credits.

This information is deemed to enable the consumer to compare different offers and to make an informed decision. Its potentially binding character may be regulated by the Member States.

Furthermore, creditors and, where applicable, credit intermediaries, are required to provide adequate explanations to the consumer enabling him to assess whether the proposed credit agreement is adapted to both his needs and financial situation. Member States may adapt to particular circumstances the manner by which and the extent to which "such assistance" is given.

1.3.2 Harmonization of the APRC (Annual Percentage Rate of Charge)

APRC is a key element of the information framework. It must be mentioned in advertising, pre-contractual information and credit agreement. The method of calculation had already been harmonized.

The new Directive sets up harmonization of the basis of calculation. It adopts a wide definition through the total cost of the credit to the consumer, involving all the costs (interest, commissions, taxes and any other kind of fees) the consumer is charged in connection with the credit agreement, except notarial costs.

The costs of ancillary services relating to the credit, in particular insurance premiums, are also included if such services are compulsory in order to obtain the credit.

Finally, the costs of maintaining an account recording both payment transactions and draw downs, the costs of using means of payment for the same purposes and other costs relating to payment transactions are included in the total cost of credit, unless the opening of the account is optional and the costs of the account have been clearly and separately mentioned in an agreement concluded with the consumer.

One can assume that this provision only applies to accounts exclusively dedicated to the management of the credit.

1.3.3 Conclusion of the credit contract

Lenders are required to assess the consumer's creditworthiness before the conclusion of the credit agreement.

They can get sufficient information from the consumer himself or, where necessary, by consulting the relevant database. This corresponds to banking practices in most European countries.

As far as cross border credit is concerned the Directive states the non-discrimination principle in access to private or public databases for creditors from other Member States.

If a credit application is rejected on the basis of consultation of a database, the creditor shall immediately inform the consumer of the result of such consultation and of the particulars of the database consulted. This information is provided in accordance with personal data protection rules.

The Directive defines the content of the credit contract in duplicating to a large extent the pre-contractual information. Of course, other contractual terms and conditions may be added.

Fewer requirements apply to overdraft facilities which have to be repaid on demand or within three months (and within more than one month).

Lastly, the conclusion of the contract is affected by the introduction of a right of withdrawal. For the sake of approximation with the provisions of the Directive 2002/65/EC concerning the distance marketing of consumer financial services, its duration has been fixed at fourteen days. In the case of linked credit agreements (see below) where a national legislation (for example the French one) provides that funds cannot be made available to the consumer before the expiry of a specific period, Member States may exceptionally foresee that if the consumer explicitly wishes early delivery of the goods or services financed by the credit, the fourteen-day period may be reduced to the period of non availability of the funds upon the explicit request of the consumer.

The right of withdrawal shall be exercised without giving any reasons. If the funds have been released during the withdrawal period, the consumer will have to repay the capital and the interest on the basis of the borrowing rate. But the directive regulates neither the availability or the non availability of the funds during the withdrawal period nor the consequences of the withdrawal of credit on the existence of the purchase or of service provision contract.

1.3.4 Early termination of the credit contract

As already provided for in the previous Directive, the borrower has the right to make at any time an early repayment, either in part or in full.

The new element is that the new Directive strictly regulates the compensation the creditor is entitled to.

The right to compensation exists only in case of fixed borrowing rate.

It provides a flat-rate ceiling which is equivalent to 1 % of the amount of credit repaid early, if the period of time between the early repayment and the agreed termination of the credit agreement exceeds one year, and 0.5 % if this period does not exceed one year.

Recital 39 reveals a useful point as to the flat-rate ceiling principle : "This approach reflects the special nature of credits for consumers and should not prejudice the possibly different approach in respect of other products which are financed by long-term funding mechanisms, such as fixed-rate mortgage loans".

No compensation shall be claimed for in the case of overdraft facilities, or if the payment has been made under an insurance contract or if the repayment falls within a variable rate period. The ceiling may "exceptionally" not be applied if the creditor can prove that the loss he is suffering exceeds this amount. Inversely, the consumer may claim for a reduction if the compensation claimed for by the creditor exceeds the loss actually incurred.

Lastly, Member States may provide that compensation may be claimed for only on condition that the amount of the early repayment exceeds the threshold defined by national law, which cannot exceed EUR 10,000 within any period of twelve months.

According to recital 40 Member States when fixing that threshold should for instance take into account the average amount of consumer credits in their market.

1.3.5 Linked credit agreements

A linked credit agreement is a credit which exclusively finances the supply of a specific good or the provision of a specific service. In addition, the two agreements must form a commercial unit which exists where the creditor uses the services of the supplier or service provider in connection with the conclusion or the preparation of the credit agreement, or where the goods or the service are explicitly specified in the contract.

According to the directive, the relationship of interdependence between the two contracts entails two consequences:

- ▶ where the consumer exercises his right of withdrawal with regard to the purchase of goods or provision of a service, based on Community law, he is no longer bound by the credit agreement,
- ▶ where the goods or services have not been supplied, or only in part, or are not in conformity with the contract, the consumer is allowed to pursue remedies against the creditor under certain conditions. The consumer must have first pursued remedies against the provider without obtaining satisfaction.

The other aspects of the interdependence between the two contracts are not harmonized and accordingly are left to the national legislations (joint and several liabilities, effect of the withdrawal of credit on the purchase agreement ...).

1.4 ASSIGNMENT OF RIGHTS

The new Directive maintains the previous provision allowing consumers to plead against the assignee any defence they could refer to against the original creditor.

It adds the obligation for the creditor to inform the consumer of the assignment of the creditor's rights to a third party. This could hamper the assignment of large portfolios. An exception is fortunately provided for where the initial creditor continues to service the credit vis-à-vis the consumer.

1.5 CREDIT INTERMEDIARIES

Where relevant, intermediaries are submitted to standard information in advertising and to pre-contractual information (see above).

Credit intermediaries must indicate in advertising and documentation intended for consumers whether they work exclusively with one or more creditors or as independent brokers.

The fee payable by the consumer must be agreed on between the consumer and the credit intermediary before the conclusion of the credit agreement.

2. MORTGAGE CREDIT: A FRAGMENTED EUROPEAN LANDSCAPE*

2.1 EXISTENCE OF COMMON STANDARDS

- Pre-contractual Information:
 - Advertising: all countries, except Denmark, impose information requirements at the advertising stage. An APRC is required in five countries, when the advertisement contains cost information.
 - Pre-contractual information provided for by the Code of Conduct (general and standardized).
 - APRC: in a majority of countries (11) the disclosure of an APRC is compulsory at the pre-contractual stage.
- No duty to advise
- Conclusion of the credit agreement: written offer

In a majority of countries (8) a compulsory written offer containing information elements relating to the future contract must be given to the borrower

- Early Repayment

A right of early repayment is provided for in 11 countries and is generally subject to conditions (restrictive for fixed rate periods in Germany: condition of legitimate interest).

2.2 WIDE DIFFERENCES REMAIN

- In few countries, the quasi-totality of protection rules is contained in the national legislation.

(France, Belgium and to a lesser extent Spain).

- Some rules only exist in one (or very few) country

A right of reflection (FR), a right of withdrawal (DE), pre-contractual information in the form of a binding offer (ES, FR, IRL), an obligation to consult databases (BE, NL), the principle of responsible lending (UK), a link between the property transaction contract and the credit contract (FR), joint and several liability (SW), application of the consumer protection law to guarantors (GR and UK).

* This presentation report is based on information drawn from the EMF study: « The protection of the mortgage borrower in the European Union » (November 2003) covering 13 Member States.

- National rules regulating the same area can differ greatly

An example of this is the right of early repayment. While the right of early repayment exists in almost all countries, the conditions for exercising the right and the costs incurred by doing so can however differ greatly from one country to another. In several countries, the loan can be repaid at any time. This is not the case in other countries. For example, in Germany, early repayment is not permitted during a fixed rate period, except in case of legitimate interest.

Differences are even more pronounced when one looks at early repayment indemnities.

In France, the compensation, which the borrower can be charged, is capped at 3% of the outstanding capital (or a semester of interest payments, which does not apply in practice). Moreover, the indemnity is waived when the repayment results from certain non-financial factors (death, unemployment, a change of employment). These limitations apply to both fixed and variable interest rate loans.

The only other national legislation, which imposes such a limit, is that in Belgium (in Spain, the legal cap applies only to variable interest rate loans).

When interest rates fall, the low legal cap allows borrower with a fixed rate loan to repay early, so that they are able to take out a new, cheaper loan. In practice, a 200 basic point decrease is enough to make re-mortgaging an attractive option. However, fierce competition amongst banks in France means that borrowers can negotiate their fixed rate, with banks often preferring to lower the rate of the loan, than to lose the customer.

2.3 THE VOLUNTARY CODE OF CONDUCT ON PRE-CONTRACTUAL INFORMATION FOR HOME LOANS

The Code has been negotiated and adopted in 2003 by European associations of consumers and the European credit sector associations. This Code is intended to be implemented by any institution offering home loans to consumers in Europe.

Institutions subscribing to the Code undertake to provide the consumers with general information about home loans on offer and personalized information at a pre-contractual stage under the form of a "European Standardised Information Sheet".

This document contains harmonized information intended to enable consumers to compare different offers.

2.4 A EUROPEAN LEGISLATIVE ACTION EXPECTED

The European Commission has announced that it will take a legislative initiative by the end of 2009 under the general item of Responsible Lending.

The text is expected to cover mortgage credit, responsible lending and credit intermediaries.

3. FRAMING MORTGAGE BORROWER CREDITWORTHINESS: THE FRENCH CASE

To ensure a sustainable long-term access to housing for French borrowers a mix of regulation and a set of lending practices as well as self regulation, that can be called responsible lending, have been applied.

3.1 THE LEGAL FRAMEWORK

The French regulation (Consumer Code) aims at both enabling borrowers to make a well-informed decision when taking out a home loan and avoiding the practice of excessive interest rates.

3.1.1 Ensuring a sound decision-making process for prospective borrowers

3.1.1.1 Information

- *Advertising*

In addition to general rules prohibiting misleading advertising, the consumer code imposes information requirements in advertisements relating to home loans.

In particular , any advertising which contains one or more elements expressed in figures shall indicate the total cost of the proposed credit, its term and the annual percentage rate of charge (APRC: comprehensive rate including all the costs [interest, commissions, taxes, etc.] the borrower is required to pay in connection with the granting of the loan).

- *Pre-contractual information*

- The credit institutions which have subscribed to the European voluntary code of conduct on pre-contractual information for home loans will provide prospective borrowers with a "European Standardised Information Sheet", in good time before the latter become bound by a credit agreement. This document contains personalized information under a standardized form enabling consumers to compare different offers.
- In any case, prior to the conclusion of the loan agreement, the lender must send to the prospective borrower a written offer describing all the loan detailed features (interest rate, APRC, total cost of the credit, loan amount, term, nature and purpose, monthly installments, amortization schedule, collateral, etc.).

This offer must be maintained for 30 days at least.

- Banks have a duty to warn prospective borrowers when a particular risk of indebtedness exists resulting from the granting of the loan.

- As far as variable interest rate loans are concerned French banks have committed themselves to providing prospective borrowers with specific information on the possible variation of the rate and its consequences on the amount of the installments, the length and the cost of the credit.

3.1.1.2 Right of Reflection

The borrowers benefit from a compulsory cooling-off period of 10 days.

They cannot accept the offer before 10 days after receiving it. And during this period no payments may be made by the lender to the borrower nor by the borrower to the lender. This prohibition aims at protecting the entire consumer's entire freedom to conclude the contract or not.

3.1.2 Prohibiting excessive interest rates: the usury ceiling

For each category of credits to individuals, the French regulation (Consumer Code) provides a maximum interest rate calculated on the basis of the average effective rate of interest applied by the credit institutions during the previous quarter for loans of the same kind presenting a similar sort of risk.

Is considered as usurious and hence prohibited, any loan granted at an annual percentage rate of charge (APRC) which is more than one third higher than this average interest rate.

Within this system, home loans constitute a single category. Therefore, interest rates of potential subprime loans, which are significantly higher than those of prime loans due to a higher risk, would definitely exceed the usury ceiling.

3.2 RESPONSIBLE LENDING: SOUND PRACTICES AND SELF REGULATION

Several aspects of the French mortgage lending practice take into account and protect the client's creditworthiness.

One can distinguish:

- Product features
- Borrower's creditworthiness assessment
- Systems of distribution and funding

3.2.1 Mortgage Product Features

- Fixed interest rate loans represent the most common type of loans granted to French borrowers (80% of the market). The interest rate remains unchanged throughout the entire duration of the loan (average length of 15 years).

As a result, consumers are protected against any increase of interest rates. There is no risk of rise in monthly installments or in the cost of the credit.

In addition the Consumer Code lays down a right of early repayment with a compensation for the lender capped at 3% of the outstanding capital (or six months of interest).

- As far as variable interest rates are concerned banks supply loans with safeguards against the increase of rates.

On the one hand, these interest rates are exclusively linked to an external index such as Euribor.

On the other hand, variable interest rates are contractually capped. In contrast, generally, no floors below which the rate might not fall, are foreseen. As a result, borrowers can fully benefit from a fall in rates while being protected against a strong increase.

- No “teaser” rates: French banks have committed themselves not to apply rates artificially reduced throughout a short period with a view to attracting customers.

3.2.2 Borrower’s creditworthiness assessment

The assessment of client ability and willingness (interpretation of past behavior) to repay the loan is the key point for lending activities and risk management.

The French banking practice relies on five principles.

- The decision to grant a loan is exclusively based on the ability of the prospective borrower to repay the loan. This ability must appear to be sustainable over the foreseeable future and result from secure income and savings.
- The creditworthiness analysis will determine the features of the loan (amount, interest rate, length, etc.).
- Credit scoring systems used to assess the probability of default are developed and individually tailored by each credit institution. Internal credit scoring allows credit institutions to precisely shape their own risk policy.
- Responsible borrowing: the borrower’s personal data necessary for the creditworthiness assessment are obtained directly from the borrower themselves.

Therefore, the borrower must ensure fairness, accuracy and transparency when passing personal information onto the lender. It is particularly the case for existing debts such as outstanding loans.

Positive databases recording borrower credit commitments do not exist in France.

Nevertheless, there is a public credit register collecting negative information about default in payments, delays, arrears, judgments, etc.

- In order to mitigate the risk of default, lenders impose on borrowers to take *out an insurance covering their personal risks such as death, disablement etc.*

3.2.3 Distribution and funding

In these two fields, organization and process constitute significant guarantees for responsible lending.

- Mortgage credits are, to a large extent, distributed by branch networks. This results in a direct contact between the customer and the bank, which is a favorable framework for the distribution of suitable products. Credit intermediaries (in particular mortgage brokers) play a limited role in France. Moreover only regulated and supervised credit institutions are entitled to grant mortgage (and consumer) credit.
- As regards the funding side, the use of retail deposits is the most widespread method to finance mortgage loans in France and in the EU (60 % of mortgage funding - although this level is decreasing).

Two complementary instruments are used:

Covered bonds which are based on the principle that covered assets remain on the bank's balance sheet. This feature constitutes a significant incentive for banks to curb the borrowers' risks of default.

Securitization is the second complementary funding tool. In such a system, banks transfer the assets (mortgage loans) to a special purpose vehicle (SPV) in return for cash. The SPV issues residential mortgage backed securities (RMBS). This instrument involves the transfer of risks from banks to investors. It favored the originate-to-distribute model in the US, which is one of the causes of the subprime crisis.

Securitization has not been used on a large scale in France.

Finally, the funding system set up in France and in continental Europe has proved to be a robust safeguard against too lax risk policies.