Brussels, 8 September 2006

European Mortgage Federation response to European Commission's consultation on the interim report of the sector Enquiry on Retail Banking

Introduction

We welcome the report and thank the European Commission services for giving the industry the opportunity to comment on it. The financial services sector in Europe is a key driver of Europe's economic strength. Access to financial services and credit are essential to the economic wellbeing of both individuals and Europe's companies, both large and small. The development of financial services is also a key pillar of the Lisbon strategy aimed at making Europe's Economy the most competitive in the world. This was re-iterated in the Kok report which particularly focused on the important role that the mortgage sector may have to play in this regard.

The table below gives some indication of the importance of the financial sector in terms of employment and output for the European Economy.

	Number of Credit Institutions-2004	Number of employees - 2004	Assets - 2004 (€ million)	Residential Lending Outstanding - 2005 (€ million)	Residential Lending Outstanding - 2005 (% GDP)
Belgium	104	71,334	914,391	98,060	32.9%
Czech Republic	68	38,666	86,525	6,016	6.1%
Denmark	202	43,877	n/a	195,762	94.0%
Germany	2,148	712,300	6,584,388	1,162,588	51.7%
Estonia	7	4,455	9,000	2,618	24.8%
Greece	62	59,337	230,454	45,420	25.1%
Spain	346	246,006	1,717,364	475,571	52.6%
France	897	n/a	4,415,475	503,600	29.4%
Ireland	80	n/a	722,544	98,956	61.7%
Italy	787	336,979	2,275,652	243,622	17.2%
Cyprus	43	8,516	38,336	2,144	16.0%
Latvia	23	9,655	11,167	2,509	19.6%
Lithuania	74	7,266	8,509	2,268	11.0%
Luxembourg	162	22,549	695,103	10,006	34.1%
Hungary	213	36,246	64,988	9,205	10.5%
Malta	16	3,353	20,391	1,519	33.8%
Netherlands	461	115,283	1,677,583	600,000	119.0%
Austria	796	72,858	635,347	53,815	21.9%
Poland	653	149,610	131,904	14,646	6.0%
Portugal	197	52,757	345,378	79,452	53.9%
Slovenia	24	11,602	24,462	1,301	4.8%
Slovakia	21	18,261	29,041	3,078	8.1%
Finland	363	25,377	212,427	65,946	42.5%
Sweden	212	39,181	582,918	159,025	55.2%
United Kingdom	413	511,455	n/a	1,414,386	80.0%
MU12	6,403	n/a	20,426,106	3,437,036	49.7%
EU25	8,372	n/a	n/a	5,251,513	48.5%

Source: ECB for number of Institutions, employees and assets. EMF for residential lending and lending/GDP
Note: Residential lending for Netherlands is an estimate

A key contributor to an efficient financial sector is the presence of an effective regulatory oversight function which among other issues would ensure free and open competition in the markets as well as ensuring confidence in the financial system. One of the roles of the regulator should be to monitor markets and to react when competition rules have been breached. According to the report, the reason for the enquiry is that 'the trend of trade between Member States, the rigidity of prices or other circumstances suggest that competition may be restricted or distorted within the common market'. However it is not clear what evidence there is to support this assertion. In line with the Commission's 'better regulation principle' it would seem that inquiries requiring active participation, contributions and analysis from the industry should be clearly focused and be the result of evidenced barriers to competition.

In terms of the methodology of the report, there are clearly issues recognised regarding to the weightings of the various survey respondents, but there is also a lack of benchmarking. This is difficult to carry out but more could have been done in terms of international comparisons and cross-sectoral comparisons. Without this the report simply presents a reasonably detailed analysis of Europe's banking industry without clear conclusions regarding its relative efficiency.

Q1. What are the main reasons for market fragmentation in Europe's retail banking sector? Please identify whether they are mainly of regulatory, structural or behavioural nature.

The nature of the barriers to integration will be a mix of all three. Barriers to integration exist for a number of reasons which will be dependent on historic, social, economic, developmental and cultural factors specific to each members state. From the mortgage sector's point of view, many of these barriers were highlighted in the Forum Group on Mortgage Credit's report. The industry together with the Commission has since been working towards policy proposals to overcome some of these barriers.

The report needs to be clear what it understands by fragmentation. Is it focusing on the level of concentration at the domestic level or at European level? The causes and factors determining the structure of the market at national level will differ considerably from those shaping the European market.

Looking at the question from a European point of view and taking a mortgage market perspective the obstacles to integration are listed in Table 1 below. We observe that many of the barriers to foreign entry are caused by the different economics of mortgage lending in each European market. Entering the market using a standalone mortgage product strategy is likely to be unprofitable in many markets and only marginally profitable in others. Indeed we observe that the estimated level of returns is a key indicator of the level of foreign entry in a market. We note that this does not preclude cross-border M&A as an entry route as in some cases commercial banks are profitable where standalone mortgages are not.

Table 1 - Integration Obstacles

Market-Induced Obstacles	Policy-Induced Obstacles
▪ Low financial returns on a standalone mortgage strategy – Product cross-subsidisation – Acceptance of low returns – Long time to profitability	▪ Different laws relating to mortgages and collateral
▪ Lack of information on foreign markets ▪ Inability to realise cross-border scale benefits ▪ Lack of access to distribution	▪ Non-transferability of mortgage loans ▪ Differences in consumer protection policy ▪ Taxation – Barriers to entry – Tax treatment of mortgage product and providers
	▪ Government intervention (e.g. take-over rules) ▪ Currency and interest rate differences ▪ Regulatory differences between markets

Source : EMF/MOW Study on the Financial Integration of Europe's Mortgage Markets, 2003

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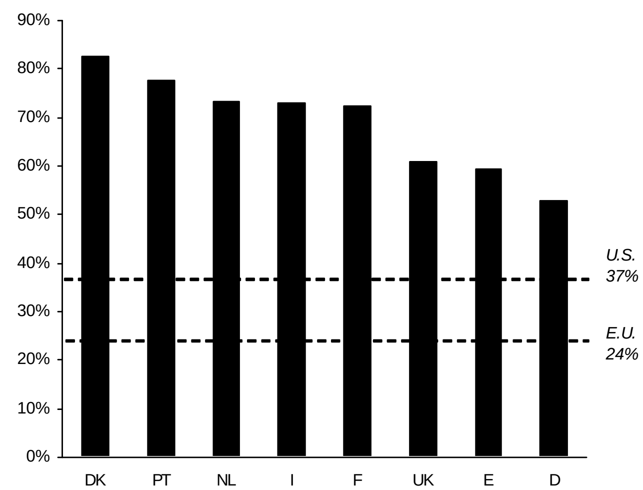
Secondly, information availability and quality is a key obstacle to greater integration of markets. Data is produced at a national level to varying degrees of quality by market. However, there is limited collection of data at a European level. The European Mortgage Federation and European Central Bank produce data on European mortgage markets but often data has different standards and formats across markets and so is very difficult or impossible to use to compare markets. For a lender looking to enter a market the availability of information in a format that he/she understands is a key enabler since its absence acts to discourage lenders from entering foreign markets.

However, differences in local regulation, law and taxation also present significant barriers to entry and so limit the formation of a single market and so any policy aimed at greater integration must consider these areas in addition to the stubborn market-induced obstacles.

Q2. What are the main causes and implications of the different level of concentration in the EU retail banking markets?

Chart 1 – Mortgage Market Concentration – Market share of 5 largest lenders (CR5)



Source: EMF/Mercer Oliver Wyman 2003

For the mortgage market, there is generally an inverse correlation between market size and concentration. This is due to the high fixed costs which the financial services industry has to carry in terms of branch networks, payments infra-structure, compliance costs, etc. Fixed cost will represent a smaller proportion of total costs fall as a proportion of overall costs the larger the market, but it means that smaller markets are only able to economically sustain a limited number of providers. For this reason the prospect of a more integrated and larger European market may prove attractive to many banks. Chart 1 shows that in the mortgage sector at present although there may be a high level of concentration at the national level, at the European level the top 5 lenders represent just 24% of the EU market compared to 37% for their US counterparts.

The implications of different levels of concentration are difficult to estimate but on the one hand greater concentration can lead to economies of scale and increased efficiency, but on the other hand it can also lead to fewer providers and a reduction in customer choice. There is clearly a balance which needs to be struck in terms of promoting European competitiveness on a global scale versus the wellbeing of national markets which could suffer if there is a reduction in the number of service providers.

<u>Banks' financial performance and pricing</u>

Q3. What are the main reasons for the varying rates of profitability and income in retail banking across the Member States?

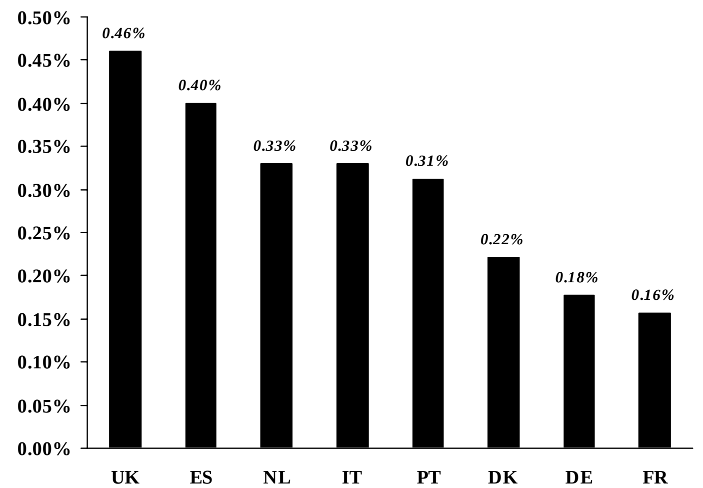
The actual level of profitability as used in the report is not necessarily the best measure of performance, particularly in an asset driven sector such as financial services. Return on Capital provides a better comparison of relative performance in different markets. As explained in the answer to question 5 below, efficient capital allocation is the sign of an efficient competitive market. Absolute measures of profitability do not necessarily convey this information.

The reasons for difference in profitability whether measured by return on capital of return on assets can vary for a host of reasons. The cost base for financial services companies will differ greatly from one country to another depending on the overall size of the market which would allow economies of scale to be attained. Also structural issues such as the range of distribution channels used for financial products will affect the cost ratios. Those countries where financial services are predominantly distributed through a branch network are likely to have higher costs than those making greater use of internet, telephone or intermediary distribution channels.

In the mortgage sector the following chart shows the margins earned on the mortgage products in 8 member states. There is clearly a large degree of variation yet there is no suggestion that one market is necessarily more efficient or more competitive than another simply based on these figures.

A final reason for differences in profitability is the different stages in the economic cycle which countries find themselves in. This will have an impact on the income of Financial service providers, not all European economies currently operate on the same cycle, for instance the German mortgage market has only grown very modestly over the past decade compared to thriving markets in UK or Spain. The absolute level of business, economic growth and growth in incomes will be reflected in the revenue which banks are able to generate.

Chart 2 – Estimated Average Post Tax Profit of Lenders on Standalone Residential Mortgage Product
(Profit as a % of Outstandings)



Source: EMF/Mercer Oliver Wyman 2003

Entry barriers in retail banking

Q4. Are there other types of entry barriers in retail banking that have not been identified in the preliminary report?

The ‘artificial’ market entry barriers identified in the preliminary report are listed as being access to payment infrastructure, access to credit databases and low customer mobility. However based on our research with Mercer Oliver Wyman, the over-riding reason for lack of integration and therefore the main entry barrier are ‘natural’ barriers. The initial investment required to capture market share makes organic entry into a new market uneconomic. Unlike other markets with much higher customer mobility where a purchase is a one-off transaction, financial services involves a long–term relationship with the customer possibly spanning a number of products. Returns on products may not always be up-front, the profitability of a product may depend on a the product being held over a longer period of time. To enter a new market a financial services provider would have to invest heavily in developing the necessary infrastructure (i.e. branch network, IT platforms, staff training, etc), they would also have to invest heavily in marketing and pricing of products to attract market share and all of this would be done without having historical data to guide their risk management processes. All of these obstacles make it difficult for a FS provider to make an economic return in the short to medium term. Investing for the very long term carries much higher risks which at present cannot be justified given the expected levels of return.

Q5. Where does competition law have a role in tackling entry barriers in retail banking?

Competition policy as described in section 3.1.1 should aim ‘ to allocate capital efficiently to firms in order to support a strong and dynamic economy.’ The allocation of capital should be based on two criteria, the level of risk and the expected level of return. On the risk side, the Capital Requirement Directive has made great strides in better evaluating the levels of risk in financials services and in ensuring that prudential capital requirements are set based on this level of risk. The allocation of capital with regards to returns still faces some distortions however because of political pressures, protectionism, regulatory burden, subsidies and guarantees. The aim of competition policy should be to create a level playing field enabling capital to move as freely as possible to where it can best be employed.

Q6. Access to credit databases and payment infrastructures are sometimes cited as a barrier to entry in retail banking markets. Are there significant barriers to access which merit further investigation?

Having a sound and efficient infra-structure for the financial system is a pre-requisite for further development. Payment systems, credit databases and in the case of the mortgage sector land and mortgage registers all form part of this infra-structure. The EMF would strongly be in favour of any measure ensuring that Member States make cross-border access to national databases possible on a non-discriminatory basis. It believes that non-discriminatory access is a necessary condition to achieve the Single Market in mortgage credit, since credit registers are one of the important instruments to assess the credit worthiness of potential borrowers and therefore to allow the lender to take a decision on a credit request by a consumer.

Likewise for the mortgage sector, the variety of registration requirements, the existence of hidden overriding interests and the difficulty in obtaining access to registration systems for consultation and registration are important barriers for lenders wishing to operate cross-border.

Completeness, accurateness and transparency as well as security of land registers are fundamental for any transaction related to real estate. Establishing a certain standard with regard to these principles throughout the EU would enhance a level playing field for credit institutions, since they are preconditions for cross-border activity

Customer choice and mobility

Q7. What are the main reasons for the low mobility of retail banking customers?

This question needs to be addressed from two standpoints, firstly mobility within a given national market and secondly mobility on a cross-border basis. At the national level, low mobility, may in fact reflect relative satisfaction with the service providers and their product offerings. In this sense, banking is a long term relationship product and therefore differs from other 'consumption' sectors where there is much less of a commitment or investment made by both parties. A further reason is that however much banks are able to facilitate switching to other providers it will still involve a certain amount of administrative burden on the consumer, in addition on some products such as long term fixed rate mortgages there will also be a financial cost to switching. These products can only be offered if some restrictions is placed on repayment through for instance an early repayment fee. Without this sort of compensation arrangement, it would not be economically or prudentially viable for the lender to fix the necessary funding in place for a long term fixed rate mortgage. Studies done by the Department of Trade and Industry in the UK have shown that there is a degree of Consumer apathy. As long as the products offered are relatively competitive, the incentives may not be strong enough for the consumer to expend the effort necessary to switch service providers.

On the issue of cross-selling, the report is relatively negative about this practice. Cross-selling however has many benefits both for the banks and their customers. Firstly the more products a customer has with the bank, the lower the administrative costs will be as they may be able to send out single statements covering a range of products and internal transactions may be completed at a lower cost than through the payments system. From a risk management point of view also, the more information the bank has about is customer the better it is able to assess the risks it faces. For instance, if a mortgage borrower also has his/her current account with the bank it allows much easier income checks. Lastly, having all the banking products with one provider can reduce the 'hassle' factor, as all the products can be viewed and managed from one website, or it reduces the amount of correspondence required. So whilst there are some cot savings for banks which are in part passed on to the consumer, there are also many benefits from the consumer's perspective to deepening his/her relationship with the financial service provider.

Turning to cross-border mobility, the issues here differ somewhat and are more related to the environment within which the consumer feels comfortable. This would include contracts and product documentation in his own language and most importantly of all obtaining products subject to their domestic consumer protection rules. This point was clearly highlighted in the consumer survey carried out as part of London Economics cost and benefit assessment of mortgage market integration. There was very little interest on the part of consumers to shop for mortgages outside of their own country. Equally consumers expressed no significant reservations about dealing with a foreign owned service provider in their own country, under their own consumer protections rules,a s logn as the product and pricing matched their needs.

Development of payment infrastructures in the context of the Single Euro Payment Area

Q8. Are there features of the payment industry that limit competition either at the level of provision of clearing and settlement services or the provision of retail banking services? Please indicate areas that merit further investigation.

Not an area of competence of the European Mortgage Federation

Q9. Are interchange fees necessary for the development of payment instruments (credit transfers and direct debits) in the EU?

Not an area of competence of the European Mortgage Federation

Q10. Are there issues related to industry initiatives in the context of SEPA that should be assessed from a competition view point?

Not an area of competence of the European Mortgage Federation

Other issues

Q11. Please provide comments on any other competition-related issues in relation to retail banking markets.

For the Mortgage Sector as a whole the European Central Bank actually raises concerns about the level of competition being too intense resulting in disappearing margins and more pressure on the industry to take risks in order to improve returns.

> *"As with mortgage products, intense competition in this market segment could raise concerns over financial stability were margins to be eroded or standards for credit risk assessment lowered."*
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> Source: European Central Bank, EU Banking Structures, October 2005

This is a theme repeated in many reports on the EU's mortgage markets, which have seen a very steady decline in mortgage margins over the past decade or so. This can partly be attributed to the benign credit conditions, improved risk management, technological advances, but clearly for all these productivity gains to be passed onto the consumer requires a dynamic and competitive market.