FIRST TRANSPOSITION ANNIVERSARY OF HARMONIZED MORTGAGES : WHAT IS THE TARGET AND WAS IT HIT?

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Abstract

The undistorted competition on the single internal market is a priority of the post-Lisbon EU, as witnessed by the strategy Europe 2020. The Directive 2014/17/EU on credit agreements for consumers relating to residential immovable property (“MCD”) is an outcome of this trend and presented as a step towards an EU mortgage credit market with a high level of consumer protection. The deadline for the MCD transposition expired over one year ago, and it is highly illustrative to research, analyze and critically discuss its nature and impact across the EU, and in the Czech Republic in particular. Indeed, what will a holistic study and year-long experience indicate, i.e. what is the target of the MCD and was it hit? The tested hypotheses are that (i) the target of the MCD can be identified and it is not what is prima facia worded in the MCD, and (ii) this partially hidden target, namely the market integration, is hit, while missing other EU objectives. This is not fully satisfactory and the EU should engage in a deeper understanding of the cause-effect for mortgages and truly reaching the expectations and needs of stakeholders. The harmonization stating and hitting the target is productive, otherwise it is contra-productive.

Key words: MCD, mortgages, residential real estate.

JEL Code: G21, K29, L51.

Introduction

Modern European integration is inseparably linked to the concept of the single internal market with the famous four freedoms of movement – people, goods, services and capital. The set of global crises in 2008, plus other internal factors, resulted in a significant challenge of the EU and its policies, including economic policies (Pelikánová & MacGregor, 2016), and led to a loss of confidence of financial market participants, to the exceptional decrease of both the Real Estate prices and the demand for Real Estate (Cvik & Pelikánová, 2016). Consequently, a massive increase in the amount of unfinished and incomplete building projects occured (Hajnal, 2015) with serious social consequences. In response, the EU, especially the European Commission, developed the Europe 2020 strategy and has been working with national governments to restore and maintain financial stability, protect savings, etc. The Directive 2014/17/EU on credit agreements for consumers relating to residential immovable property ("MCD") is an outcome of this trend and presented as a step towards an EU mortgage credit market with a high level of consumer protection. Since the deadline for the MCD transposition expired on March 21, 2016, we have the opportunity to perform a holistic, critical and comparative study of the MCD and its impact across the EU, in particular in the Czech Republic, as indicated by data and information from the first year. The literate and teleological interpretation of legislation and case law is joined by economic indicators and hard data on the accessibility, amount, granting and interest rates of mortgages along with soft data about the perception by academics, the professional public, and even regular consumers. The comparative cross-examination of the yield knowledge and the assessment of the economic, legal and social trends related to the MCD allows for addressing of the leitmotif questions: (i) What is the ultimate target of the MCD? (ii) Does the one year experience suggest that it is hit? The underlying hypotheses are that, despite inconsistency and legislative obscurity, (i) the target can be identified and it is rather the market integrated from above than the bottom up protection of consumers and (ii) this target is generally hit, but this hitting leads to missing other key EU objectives. This is clearly demonstrated in the Czech case study using a typical mortgage scenario 2016-2017. The paper culminates in its conclusions where the addressing of the duo of key questions and their underlying hypotheses is complemented by offering suggestions about further exploration, preliminary recommendation and general glosses.

1 The capturing of the ephemeral target of harmonized mortgages

The global crisis pointed out that housing markets in the EU are big causes of instability (Whitehead et al., 2014), that the profitability downturn hits all EU members states, their industries and businesses of all sizes (Lacina & Vavřina, 2014) and negatively impacted even consumers. The pre-MCD EU consumer law protecting consumers through (i) information and (ii) fairness (Méndez-Pinedo, 2015) failed mortgagors-consumers in the crisis. The MCD made a move by extending this duo to a quartet, i.e. addresses (i) the information, (ii) the fairness, (iii) affordability and (iv) responsible lending (Cvik & Pelikánová, 2016). However, this quartet is rather vague and needs to be understood in the light of the MCD, which, in its turn, is a EU Directive and thus should be interpreted while using the literate approach and even more the teleological. Indeed, this exploration is crucial, because it leads to the discovery of a true target of the MCD and should be the guideline for not only its application but as well as its transposition.

The literate exploration of the MCD reveals very clear and conclusive statements about its purpose and target. They are included both in the preamble as well as in its body. Namely, pursuant to the point 15 of the Preamble "*The objective of this Directive is to ensure that consumers entering into credit agreements relating to immovable property benefit from a high level of protection.*" and to the point 31 of the Preamble "*The applicable legal framework should give consumers the confidence that creditors, credit intermediaries and appointed representatives take account of the interests of the consumer, based on the information available to the creditor, credit intermediary and appointed representative at that moment in time and on reasonable assumptions about risks to the consumer's situation over the term of the proposed credit agreement. ... A key aspect of ensuring such consumer confidence is the requirement to ensure a high degree of fairness, honesty and professionalism in the industry, appropriate management of conflicts of interest including those arising from remuneration and to require advice to be given in the best interests of the consumer.*" The same tone continues even in the Art.2 about the level of harmonization "*This Directive shall not preclude Member States from maintaining or introducing more stringent provisions in order to protect consumers, provided that such provisions are consistent with their obligations under Union law.*" Therefore, the literate approach indicates that the ultimate beneficiaries are consumers and the target purpose is to protect them, their confidence. The Czech Act No. 257/2016 Coll., on consumer credit ("Czech consumer credit act") transposes the MCD into the Czech national law and embraces even more "pro regulatory" in the name of the consumer. The impressive number of 179 articles attempts to heavily regulate providers of mortgages, imposes an extensive information duty on them, underlines creditworthiness, etc. Based on Art. 25 of the MCD, the Czech consumer credit act in its Art. 117 allows a sanction-free early repayment of up to 25% of the mortgage debt annually.

The teleological and contextual approach suggests that the EU is often inclined to combine the consumer protection, the protection of the undistorted competition and the unsettled integration as such (Pelikánová, 2013), and this even in a "one size fits-all" manner disrespecting national particularities (Cvik & Pelikánová, 2016). The Czech acts remain generally silent about purposes and targets and thus the exploration of the intended target should be searched in milestone strategic documents, especially in the Europe 2020, official European Commission statements and case law generated by the Court of Justice of EU ("CJ EU"), e.g. C-415/11 Aziz. Their cursory overview indicates the prime purpose of the integration, namely integration almost "at any price" as already described by academia on the EU, as well as national, levels (Keen, 2010)

The doctrinal approach reveals that the MCD is a hybrid and compromise outcome inspired by both common law and continental law traditions, while perhaps the common law touch prevails (Cvik & Pelikánová, 2016). It relies more on English (common) law concepts, methods, and terminology, but needs to be transposed in predominantly continental (civil code) law countries (Pelikánová & MacGregor, 2016). This naturally creates a legal tension which is magnified by national transposition and their particularities. In such a potentially disperse setting, the unifying element is obviously the integration. In other words, pragmatically the local differences can be overcome only if the highest target is taken – the EU. Indeed, European integration is a concept perceived as a complex unification procedure entailing an abundance of complicated processes in various fields (Cvik & Pelikánová, 2014) and the top pro-integration internal tandem, the European Commission and CJ EU, seem to closely work to make the integration even closer.

2 The target(s) hit – what harmonized mortgages cause nationally

Europe 2020 is a strategy on smart, sustainable, and inclusive growth in the united Europe and in order to achieve it, it has been set up with a strong and effective economic governance, which coordinates policy actions on the EU and national levels. Likewise, in the case of accounting rules, where Czech standards and general procedures need to be brought as close as possible to all encompassing European regulations (Jindrichovska & Kubickova, 2017). Basically each and every document or statement of the European Commission refers to Europe 2020 and to intense integration. This tone is voiced as well by other key EU institutions, and in particular with reference to the economic policy and competition on the single internal market, including the digital market. However, does this drive allow creating directives, like the MCD, able to serve other goals? Yes, but specifically in the case of MCD, can and does it hit the (alleged) target – informed, fair, affordable and responsible lending, and generally better care and protection for consumers? Holistically and pragmatically, it is efficient to select one jurisdiction and observe the one year experience with the transposed

MCD harmonization, while focusing primarily on one objective quantitative criterion which attracts a large share of consumers attention – the mortgage interest rate, and secondly on the availability of mortgages as such in relation to own resources.

Since the Czech Republic definitely belongs to countries witnessing a lot of issues with miscarriages of justice linked to mortgaging, e.g. see the infamous case of the Modrá Pyramida – Komerční banka (Society General) in Prague (Pelikánová & MacGregor, 2016) and the Czech transposition of the MCD was massive, the Czech one year experience with a newly harmonized mortgage regime is appropriate for target testing. If we assume that the target is what the literate approach indicates, i.e. what is worded in the MCD, then Czech consumers should have enjoyed better informed and educated decisions, more information, more professionalism and more fairness and protection in general. So primarily, mortgage interest rates should not increase and the availability of mortgages should not decrease. However, the opposite is true. Czech consumers interested in or getting mortgages in 2017 are definitely less happy than those in 2016. Their happiness ended in December 2016 when the new Czech Act on consumer credit took full effect and their ephemeral right to repay 25% annually sanction-free was "compensated for" by an interest rate increase. In addition, their "protection" by the law leads to the prohibition of 100%, 95% and possibly even 90% mortgages, while they are induced to take a "plain" consumer loan. The Fincentrum hypoindex is a valuable tool indicating average mortgage interest rates.

Tab. 1: Fincentrum Hypoindex - Average mortgage interest rates 4/2016-4/2017

4/2016	6/2016	8/16	10/2016	12/2016	2/2017	4/2017
1.94%	1.87%	1.84%	1.81%	1.82%	1.87%	1.96%

Source: Authors´own processing based on Fincentrum (2017).

In 4/2016, the average mortgage was CZK 1.88 million CZK at the rate of 1.94%, while in 10/2016 it was CZK 1.98 million at 1.81%, and in 4/2017 it was CZK 2.02 million at 1.96%. The increase in the Hypoindex (average mortgage interest rate) is especially caused by mortgages with a high LTV, while mortgages for over 90% are prohibited. In addition, banks can provide only 15% of new mortgages to their portfolio with LTV between 80% and 90%. Further the Czech central bank acquired competencies allowing adding further restrictions and e.g., it considers the prohibition of mortgages exceeding five annual incomes of the mortgage applicant. According to the Czech Statistic Office, the average monthly gross income was around CZK 27 thousand in 2017, but the median was only around CZK 21 thousand. Hence, the net income of an individual does not significantly exceed CZK 20 thousand. If we consider two such applicants combined, the limit is CZK 2.4 million. Interestingly, this reflects the fact that the average mortgage is CZK 2.02 million and, as it is well known, Czech conservative consumers managed to enter into mortgage deals which they could afford and they truly repay them by the due date. The use of 90% mortgages was not exceptional and reflected the plain fact that people buying their first piece of residential real estate did not have too much cash and the same applied to people repaying the 1st mortgage and now desiring to buy another piece of real estate and so to take on a new mortgage. Boldly, under the old law, they could just save CZK 120 thousand (5% mortgage) and apply for a mortgage for CZK 2 million. Now they must save at least CZK 240 (10% mortgage) and still risk that the bank, due to the restriction “max 15% on LTV 80-90%”, will not be allowed to grant them mortgages. And even worse, the bank perhaps will be allowed, but plainly will not have the motivation to do so … at least not for 1.96%. As a matter of fact, basically all big banks have increased their rates in the fear of the early repayments (which are, due to the Czech setting, highly unlikely) . Currently, the typical 5 years fixed mortgage leads to, generally, much higher interest rates, if obtained from “traditional” banks established on the Czech market for decades (ČSOB, Česká spořitelna, Raiffeisen, Komerční banka). Interestingly, “new comers” (mBank, Fio banka) manage to keep interest rates low (Fincentrum, 2017).

Tab. 2: Fincentrum Hypoindex - Mortgage interest with 5 year fixation in 3/2017

Bank	Fio banka	mBank	ČSOB	Česká sp.	Raiffeisen	Kom.ban.
Interest	1.58%	1.74%	1.99%	2.19%	2.19%	2.29%

Source: Authors´own processing based on hypoindex.cz

Czech consumers can overcome the ill-conceived protection by the Czech consumer credit act, allowing them hypothetically to repay annually 25% of their mortgages, by using a new bank which does not increase the interest in the (false) expectation of massive repayments causing a dramatic loss of profits to banks. However, even these new banks must respect strict rules set by the Czech consumer credit act and Czech central bank empowered to further develop this regulation. A significant part of the population has a “cash-flow” issue – how to get 20% or, better yet, 30% of the real estate price to be paid down? Often the only viable option is to take on a consumer (non residential) loan at a rate reaching up to 10%. This is legally obscure and economically highly inconvenient for Czech consumers, which by the Czech Consumer credit act transposing the MCD got rather a stiff punishment and complications instead of protection and simplification. This is perfectly demonstrated in a case study presented in Ekonom (Němec, 2016). This case study covers real estate of a fair market value of CZK 3 million and a consumer paying down 20%, i.e. LTV=80%, and taking a mortgage for 20 years with 5 years fixation. As expected, the interest rates offered will be lower by new banks and higher by the older well-known banks. Nevertheless, the monthly payment should not exceed CZK 14 thousand, i.e. 2/3rds of an average net monthly income of an individual. This looks doable, perhaps even in consumer interest.

Tab. 3: Case study – interest rates in 4/2017 for CZK 2.4 million for 20 Yr with 5 Yr fix

Bank	mBank	Fio Banka	Česká spoř.	Komer.ban.	Hypotéč.b.
Interest	1.99%	2.18%	2.19%	2.29%	2.79%
Monthly	CZK 12 130	CZK 12 347	CZK 12 396	CZK 12 515	CZK 13 059

Source: Authors´own processing based on Ekonom (Němec, 2017)

It should not be forgotten that the missing CZK 600 thousand needs to be obtained by general (not residential) consumer credit. This leads to almost CZK 10 thousand monthly, i.e. the monthly mortgage and consumer credit loan payments exceed CZK 21 thousand, i.e. an average monthly net income, and perhaps even an average monthly brut income.

Tab. 4: Case study – interest rates for CZK 600 thousand to be repaid in 7 Years

Bank	mBank	Fio Banka	Česká spoř.	Komer.ban.	Hypotéč.b.
Interest	9.9%		7.9%	6.9%	
Monthly	CZK 9 930		CZK 9 388	CZK 9 111	

Source: Authors´own processing based on Ekonom (Němec, 2017)

Hence, in our study case a consumer taking a mortgage for CZK 3 000 000 in 10/2016, to be paid within 20 years, ends up paying CZK 3 577 927, while a consumer in the exact situation in 4/2017 will have a worse interest rate and will have to split the amount between the mortgage and consumer credit (assuming he will get it and at a very good RPSN 9%), and ultimately will pay CZK the 3 713 879, i.e. by CZK 135 952 more. Without the down payment issue, the straight difference between the total mortgage payment for 20 years at 1.81% (CZK 3 577 927) and at 1.96 % (CZK 3 628 736) is CZK 85 143.

Tab. 5: Case study – total expense on CZK 3 million real estate if a mortgage taken in 10/2016 and 4/2017

Begin	Mortgage	Mortage Interest Rate	Paid on Mortage	Paid on Consumer Credit for CZK 600 000 for 7Yr at 9% RPSN
10/2016 (monthly)	CZK 3 000 000	1.81%	CZK 3 577 927 (CZK 14 908)	N/A
10/2016 (monthly)	CZK 3 000 000	1.96%	CZK 3 628 736 (CZK 15 120)	N/A
4/2017 (monthly)	CZK 2 400 000	1.96%	CZK 2 902 989 (CZK 12 095)	CZK 810 890 (CZK 9 653)

Source: Authors´own processing while using http://kalkulacky.idnes.cz/cr_hypotecni-kalkulacka.php?suma=3000000&urok=1%2C81&rok=20&interval=12&typ=po

Consumers are disappointed and attempt to get mortgages before this situation becomes even worse. Indeed, parts of the Czech consumer credit act are not yet fully applicable, in addition, the Czech central bank does not yet seem to have stated its last word. Real estate experts share similar feelings and do not hesitate to voice them, see the pragmatic statement of Evžen Korec, the president of Ekospol "Banks manage to assess the creditworthiness of their clients. The Czech central bank should not mix into it" (Němec, 2016). Despite that, the Czech Central Bank seems to mean business, and its governor, Jiří Rusnok, stated in Hospodářské noviny that the Czech Central Bank will go for rigorous enforcement, i.e. to check out how people got the money for their down-payment before getting a mortgage. An unbiased observer can ask why? Is this really what the MCD targets? Primarily, is this about a more vigorous and intense integration, more effective and efficient EU? Hardly. Secondly, is this for a more informed, fair, affordable and responsible lending? For sure, getting an expensive consumer loan in addition to the mortgage is not really fair and affordable. Perhaps we are informed about it, but this is not responsible lending! It seems that the MCD, with its slightly blurred target, was transposed, regarding targets, in an even more blurred manner by the Czech consumer credit act. At the same time, a lot of both byzantine and detailed rules were added, the Czech central bank received power to go even more in depth and it appears that it might not only go for it but even rigidly enforce it. The pendulum swings not in favor of the alleged beneficiaries – Czech consumers wanting to get a mortgage.

Conclusion

Smart, sustainable and inclusive growth is desirable, and the well informed, fair, affordable and responsible lending is definitely an attractive and legitimate purpose. However, this was only a secondary target of the MCD. Indeed, the omni-important integration takes pride of place, and this is understandable, even if partially controversial. Since the Czech Republic did not have a developed mortgage regulation and abuses have occurred, the MCD was, despite the target duality, a good guideline and opportunity to make the granting of mortgages in the Czech Republic informed, fair, affordable and responsible in order to protect consumers. The primary, perhaps preliminary, data from the first year are not conclusive about hitting the integration target, but are even contrary to the alleged hitting of the second target. It will be relevant to observe the evolution, especially (i) whether consumers will take advantage of the right for early repayment, for which they already paying via higher interest rates, especially by large traditional markets, (ii) whether the Czech central bank will truly enforce mortgage granting restriction rules. The selection of one (not two!!!) priority and consideration of the true interests of the (alleged) beneficiaries is a big challenge in this field. More attention deserves the cause-effect for mortgages, the avoidance inconsistency of the MCD and national legislation, the necessity to clearly prioritize re economic policies while considering all (!) stakeholders, the duty to recognize and respect diversity. The Czech case study leads to a humble admission, with respect to the Czech Republic as well as EU and other EU members, that the conceived and target hitting harmonization is productive while misconceived harmonization missing targets or hitting wrong targets is contra-productive.

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