ESRB
European Systemic Risk Board
European System of Financial Supervision

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ESRB response to the European Commission consultation on the review of the mortgage credit directive

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Dear Mr Ducoulombier,

I am writing to you with reference to the review of the mortgage credit directive (MCD) carried out by the Commission services. Although the deadline for replying to Commission's consultation has already expired, the European Systemic Risk Board (ESRB) would like to share with you its proposal to include borrower-based measures (BBMs) in EU legislation, as the ESRB's proposal also covers the MCD. This letter was discussed with the ESRB Advisory Technical Committee and agreed by the ESRB General Board in a written procedure.

The ESRB is responsible for the macro-prudential oversight of the financial system within the Union and contributes to the prevention and mitigation of systemic risks to financial stability in the Union. Given its mandate, the ESRB is contributing to the Commission's Call for Advice (CfA) on the 2022 Review of the EU Macroprudential Framework. The proposal to include BBMs in EU legislation is an important element of the ESRB's response to the CfA. The ESRB considers that, given the importance of residential real estate (RRE) markets and their financing for financial stability as well as the strong economic and financial interconnectedness between Member States, there should also be a common minimum basis for BBMs in national legal frameworks. This proposal is further elaborated in the ESRB's Concept Note, in which the ESRB takes a more comprehensive view and proposes enhancements to the existing EU macroprudential framework, responding not only to the questions explicitly raised by the Commission in its CfA, but also looking at areas of further work for the next decade. Both the ESRB's Concept Note and its CfA response can be accessed via this secure **link**, in our platform.

BBMs can help to ensure sound lending standards and higher resilience of borrowers. International experience shows that risks to financial stability from developments on RRE markets tend to build up when there is a combination of strong house price growth, strong housing credit dynamics and eroding credit standards. BBMs can help mitigate these risks by ensuring minimum credit standards for new housing loans. The most frequently

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used measures are limits to loan-to-value (LTV), debt- or loan-to-income (D/LTI), debt or loan-service-to-income (DSTI/LSTI) and maturity, and amortisation requirements. The ESRB highlights in its Concept Note and in its response to the Commission's CfA that including BBMs in EU legislation would complement the existing set of macroprudential instruments for the banking sector and emphasises the financial stability dimension of BBMs. For this reason, a minimum set of BBMs should be included in the Capital Requirements Directive (CRD).

The use of BBMs is not only beneficial from a financial stability perspective, but also for consumer protection, as it tends to be associated with lower mortgage credit growth, higher resilience of households (including the most vulnerable households), and higher resilience of credit providers. By reducing the procyclicality of credit, the scale of banking crises and/or their negative economic consequences are reduced. Consumption and investment are less volatile, contributing to a more stable macroeconomic environment and facilitating economic growth in the medium term as, in particular, borrowers are less at risk of not being able to repay or service their debt regularly without significantly reducing their consumption. The latter may be the case because with lower volatility of RRE-prices household wealth is also less likely to experience a sharp decline.

From a consumer protection perspective, it is essential that the assessment of creditworthiness takes into consideration all necessary and relevant factors that could affect the consumer's ability to repay the loan over its lifetime. To carry out this assessment, the MCD explicitly refers to specific criteria such as the loan-to-value or loan-to-income ratios. These criteria are thus used both to establish sound lending standards and to address risks to financial stability stemming from RRE financing: BBMs therefore help support both consumer protection and financial stability, in particular, as BBMs also form criteria used to assess a consumer's creditworthiness as per the MCD.[1]

Although sound lending standards serve both consumer protection and financial stability, the competences and scope of application of the EU legal framework for consumer protection on the one hand and for financial stability on the other are not congruent in this respect. Nevertheless, EU legislation would also benefit from the inclusion of BBMs in the MCD. In particular, the different objectives of MCD and CRD do not preclude the dual purpose of BBMs in terms of their legal availability. Therefore, BBMs could be explicitly stated in the MCD as the MCD already mentions aspects of financial stability and also refers to the Financial Stability Board's

[1] See Recital 55 of Mortgage Credit Directive.

Principles for Sound Residential Mortgage Underwriting Practices. This dual legal availability does not however mean that both consumer protection and financial stability must then be invoked in each application of a BBM.

Furthermore, the inclusion of BBMs in the MCD could address the fact that in several Member States other types of lenders are also active in the financing of RRE. Unlike the CRD, the MCD does not cover a specific group of lenders, but applies to all types of lenders, provided that the loan is a mortgage loan. Therefore, to ensure a level playing field and prevent regulatory arbitrage, it would be important to extend the scope of the BBMs to all types of lenders. In this way, consistent rules would apply to all lenders when granting mortgage loans and BBMs could be applied in an activity-based manner, an approach which the ESRB supports in principle. Enshrining BBMs in the MCD could thus allow authorities to apply macroprudential BBMs to loans granted by all types of lenders, including insurance companies, investment funds and pension funds. Such an approach would not only minimise regulatory arbitrage but also eliminate the possibility of circumventing restrictions that apply to RRE funding due to the imposition of BBMs on banks as lenders.

We stand at your disposal should you wish to discuss in more detail the benefits of including BBMs in EU legislation and into the MCD, especially regarding the development of a consistent approach to macroprudential BBMs and creditworthiness assessments, as well as the institutional set-up and the different objectives of BBMs.

Yours sincerely,

Francesco Mazzaferro

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Head of the ESRB Secretariat

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Review of the EU Macroprudential Framework for the Banking Sector - Response to the call for advice

Review of the EU Macroprudential Framework for the Banking Sector - Concept Note

Review of the EU Macroprudential Framework for the Banking Sector - Background Report