



> AN AMERICAN REVOLUTION



By Tim Skeet, Managing Director and Head of Covered Bonds, Merrill Lynch

Turmoil and Troubles

These are unprecedented times. There is no one in the markets today, regardless of vintage, who has experienced such a confluence of troubles as have afflicted the

state of the US mortgage market. Mortgage banks are collapsing and 'mom and pops' are defaulting on mortgage loans, leaving their keys on the mat. As a consequence mortgage lenders such as Countrywide were hit hard. Countrywide ended up being swept into the arms of a bigger better capitalised bank. More recently another Californian institution, IndyMac Bank, has succumbed, with long queues of depositors winding down Main Street. If this has worried the politicians, worse was to come. Hedge funds and other short sellers have laid siege to those hitherto unassailable virtual agencies, the Freddie and Fannie siblings, forcing the government to attempt successively more explicit expressions of support. The malaise of the markets has intensified to unprecedented heights.

Big Words - But What Action?

What is to be done? Understandably regulators and their political masters are casting around for ideas. From the classical grandeur of the Treasury building adjacent to the White House in Washington, the Treasury team under Hank Paulson, surveys the debris and wreckage of the financial markets and looks for inspiration and ideas. Amongst other suggestions one recent development, relevant to readers of this journal, is the Treasury's intention to sponsor a very European instrument- the covered bond. This represents but one element in the rebuilding of a vibrant residential mortgage market for the future. Currently the focus is uniquely on prime residential mortgages as collateral and not public sector, commercial or other classes of underlying assets. On July 28th the

Treasury published their document on covered bonds entitled, 'Best Practices for Residential Covered Bonds'. Announced with fanfare at a crowded press conference in Washington presided over by Hank Paulson himself and attended by the great and the good of the US regulatory community this innovative document sets out a roadmap for the development of a new market segment.

Introducing covered bonds into the US is hardly an original thought. The most recent, but ultimately frustrated and failed attempt to bring this instrument to the US, dates from late 2006 and early 2007. As with most other brave beginnings, the targeted US covered bond as issued by Bank of America or those imported from Europe came to a grinding halt as the markets fell apart. Now, amongst a host of other measures, the authorities have re-examined the instrument to see if it might not offer value and play a part in the future rebuilding of the US mortgage market. This initiative has been the stuff of several speeches by Secretary Paulsen, Chairman Bair of the FDIC and others through the spring and summer. What however is being done in practical terms to resurrect the product?

In mid June, representatives from across the industry were summoned to a special meeting in the historic Cash Room at the Treasury in Washington. Unprecedented and extraordinary in many ways, this gathering represented an historic attempt to re-launch the covered bond into the US market, this time with the full support of the authorities and all relevant interested parties. This kick-off meeting possibly represented either the beginning of

An American Revolution	1
The new Rome I Regulation	3
Commission publishes new Anti Discrimination Measures	4
News in brief	5
Agenda	7

markets in recent months. Moreover, regulators have struggled to match policies to events. Once the armoury of the conventional and hitherto tested instruments has been exhausted, there is but recourse to inspiration and imagination. The old certainties of the market have evaporated like the morning mists. The dislocation and colossal tremors that have shaken the financial world had their epicentre in the US subprime market. Though the shock waves have spread to all corners of the global economy, the US remains particularly afflicted, with almost weekly fresh bad news creating bleak new headlines.

Near catastrophic write-downs in asset backed values have humbled Wall Street and beyond, but the main concern domestically in the US is the



something big, or indeed the end of something rather small. From that point to the end of July, market participants and the Treasury team worked hard to create a series of statements that culminated with the announcements of July 28th. This was fast and effective work.

Those Hessians!

The historic location of the Cash Room for that meeting in June gave the meeting a certain gravitas. The Cash Room itself dates from 1869, but the US Treasury as an institution is as old almost as the Pfandbrief, being formally created by an act of Congress in 1789. The first covered bond or German Pfandbrief dates from 1770. In that year the American leaders were naturally unaware of the potential of this interesting financial instrument, as they were on the brink of combat with, amongst others, certain of the citizens of the German state of Hess who were in the employ of the British army. Centuries later the Hessian town of Frankfurt claims to be the European covered bond's financial centre. Some 30,000 Hessian troops fought with the British unsuccessfully to subjugate the American revolutionaries, and indeed some 5000 stayed on at the end of the war. There is an irony in all this of course. It seems that just as those 30,000 late 18th century German imports were unwelcome, today a late 18th Century German idea would represent a very welcome import for this late 18th Century American institution and State.

What however is the proposal? The speed with which the FDIC has clarified its rules following its consultation with industry and the subsequent publication of the Treasury paper was impressive and unlike the long drawn out processes typical in Europe. This was only one step towards action and the development of the market. The FDIC

and Treasury template alone are not, however, able to do anything more than set certain parameters. Indeed, the FDIC's interest in the instrument appears more apparent than real. Nevertheless, US Regulators faced with the credit crunch are looking to sponsor instruments which should offer funding diversification, advantageous terms and long maturities. Moreover, covered bonds represent healthy risk taking and stronger underwriting standards in the mortgage industry.

Enter therefore the Department of the Treasury team, conscious that a new instrument and market initiative requires the forging of a consensus between several parties - issuers, investors and intermediaries. For covered bonds to thrive there must be the promise of deliverable liquidity and buyers in sufficient numbers at reasonable rates. However, today's Hessians in Frankfurt have little interest in revolutionary American products, and have put their Euros elsewhere. The WaMu downgrading and worsening US economic headlines make for painful reading in far off Europe. Any attempt to crank start the US covered bond market must be centred on inspiring US demand for a US style product.

A Template for Action

The Treasury's 'Best Practices for Residential Covered Bonds' document that will set the ground rules for the future development of the asset class and hopefully provides US investors with an incentive to look closely at the product. Specific legislation is not currently a realistic possibility and arguably for a US investor base less sensitive to the traditions of the market, less a necessity.

Now the US Department of the Treasury has set out its stall. The 'Best Practices' provides common standards and addresses some of the objections that various parties

may have had to being involved in the asset class and it aims to prove that the US covered bond is not just a transient expedient born of political will. The document is not designed as a static document, but rather as a pointer for where the market needs to go. Significantly, the Treasury team have already turned their words into actions by reaching out to the different groups of interested parties, explaining their ideas and cajoling relevant players to play ball resulting in the ancillary statements of intent from issuers, investors, and market makers that were also published on July 28th. This is a very exciting development and certainly unprecedented in its comprehensive pulling together of relevant people and organisations.

It is too soon to judge to what extent the ideas that were launched around that table in the Cash Room in the Treasury in Washington that June morning will lead to something meaningful or over what timeframe. What is certain, however, is that this is part of a bold initiative to map out the future of the US financial markets. It would be wrong to expect too much, but equally wrong to underestimate the resolve of the Americans. Covered bonds are not the solution to the problem of market liquidity or the difficulties of the mortgage industry in the United States. Covered bonds, with the intrinsic need to retain and not pass on risk, are instruments that could in future offer fresh sources of liquidity and new investors to the market, bringing renewed discipline. The Americans may have taken over two hundred years to potentially embrace an idea which hails from the time of the nation's own founding, but what we are witnessing is a brave attempt to graft a concept onto the vast US capital market, and it will be to everyone's benefit, Americans and Europeans alike, that this initiative meets with success.



> THE NEW ROME I REGULATION



By Kerstin Fisher,
Head of Legal Affairs, EMF

Successor to the Rome I Convention 1980¹, the Rome I Regulation is the new Community instrument defining the law applicable to contracts in the EU27². The Rome I Regulation entered into force

on 24 July 2008, and will apply as of 17 December 2009 to contracts concluded after this date. As regards its territorial scope, it is not applicable to Denmark and the UK as these Member States have not opted in, whereas Ireland has made use of this option³.

The conversion of the Convention into a Community instrument reflects developments on the Brussels Convention 1968 on jurisdiction, which was already replaced by the Brussels I Regulation on 1 March 2002. In view of the objective of reducing the risk of forum shopping⁴ across the EU, these initiatives seek to unify conflict-of-law rules in the Member States, and to ensure that the courts in all the European Union countries apply the same law to the same international contract and situation.

The Vienna Action Plan had acknowledged the importance of the compatibility between conflict-of-laws rules for achieving the objective of mutual recognition of judicial decisions, and the 2000 Mutual Recognition Programme had set forth further measures to harmonise the conflict-of-laws rules. The conversion of Rome I into a Community instrument aims at achieving these objectives by:

- (1) standardising relevant rules of private international law in the Member States,
- (2) conferring a power of interpretation on the European Court of Justice, and
- (3) facilitating the transposition of standardised conflict-of-law rules in the new Member States.

Following the European Commission's Green Paper in 2003 on the question of whether the Rome Convention 1980 should be converted and modernised on the substance, and a public hearing one year later (on 27/01/04), the Commission adopted a formal proposal for a "Rome I" Regulation by the end of 2005, which the Council and the European Parliament approved in co-decision.

A new feature regarding its scope of application (Article 1) is the exemption for insurance contracts other than life assurance, with the object of providing benefits for employed or self-employed persons belonging to an undertaking or group of undertakings, or a trade or group of trades, in the event of death or survival or of discontinuance or curtailment of activity, or of sickness related to work or accidents at work.

The central feature of the system continues to be the principle of **freedom of choice**, whereby the parties are free to choose the law applicable to their contract. **Article 3**, the provision laying down this principle, has been reformulated with a view to achieving greater legal certainty. The concept of "mandatory rules" under the Rome Convention has been clarified, and the terminology now refers to "law (...) which cannot be derogated from by agreement". Finally, the relationship of Community law with third country law has been clarified: the choice of third country law shall not prejudice the application of "mandatory" Community-law⁵.

Where the parties have not determined what law is to be applicable to their contract ("**absence of choice**"), **Article 4** Rome Convention used to lay down the principle of the "closest connecting factor", followed by a legal presumption that the law of the country applies where the characteristic performance of the contract takes place. The starting point of the new Rome I Regulation is a list of typical cases (provision of services, right in rem, MiFID etc.) for which the applicable law is identified individually. For service providers, for instance, this is the law of the service provider's habitual residence (with the

exception of consumer contracts, see below). Should none or more than one of the cases mentioned in the list apply, the characteristic performance becomes relevant, unless the case is "manifestly more closely connected" with a country other than that. Only if the law applicable cannot be determined does the country of the "closest connecting factor" become relevant.

Like the Brussels I Regulation (dealing with jurisdiction), the Rome I Regulation contains special rules to protect the "weaker" parties, meaning consumers and employed persons. The Commission proposal for **Article 6** on **consumer contracts** had been amended by the European Parliament, with the following result:

The law of the consumer's habitual residence applies by default subject to the following conditions:

- professional pursues his activities in the country of the consumer's habitual residence or directs his activities to the country, among others, of the consumer's habitual residence; **and**
- the contract falls within the scope of such activities. (Article 6 paragraph 1).

However, even if Article 6 paragraph 1 applies, parties to a consumer contract can still exercise the freedom of choice according to Article 3, but this choice must not deprive the consumer of the protection of the "mandatory rules" applicable in the country of his habitual residence according to Article 6 (paragraph 1).

Exemptions from this general rule of the law of the consumer's habitual residence are foreseen for a number of

1 The Convention came into force on 1 April 1991

2 Apart from Denmark and the UK, see second paragraph below.

3 See the Protocols on the positions of Denmark, Ireland and the United Kingdom, respectively, annexed to the EU and EC Treaties.

4 "Forum shopping" describes the phenomenon that one of the parties might bring an action in the courts of a particular country not because that court is best placed to settle the dispute (e.g. being closest to the evidence), but because it applies the law most favourable to this party's case.



contracts, notably for rights *in rem* in immovable property or tenancy of immovable property (other than timeshare) and MiFID. In these areas, the law of the consumer's habitual residence is not the law applicable by default but e.g. in the case of immovable property, the *lex rei sitae*. Financial instruments and UCITS are also subject to this exemption, as long as they do not constitute the provision of a financial service.

It is also worth noting that Article 14 on voluntary assignment and contractual subrogation now clarifies the definition

of assignment for the purpose of the Rome I Regulation, to include outright transfer of claims, transfers by way of security and pledges, as well as other security rights over claims.

A first report on the application of the new Rome I Regulation is foreseen for 17 June 2013. However, by 17 June 2010 already, the Commission is to deliver a report on the question of the effectiveness of an assignment / subrogation of a claim against third parties, and on the priority of such a claim over third party rights. The Rome

I Regulation's Review Clause foresees that the report on the effectiveness of the assignment is to be accompanied, if appropriate, by a proposal to amend Rome I and an accompanying impact assessment.

The EMF is currently looking into the application of Rome I in the different Member States, in particular with regard to Article 6, and will report on experiences with the application of this provision at national level.

⁵ I.e. law that cannot be derogated from by agreement, in the sense of above reference.

> COMMISSION PUBLISHES NEW ANTI DISCRIMINATION MEASURES



By Jennifer Johnson,
Senior Adviser, EMF

On the 2nd of July 2008, the Commission adopted a proposal for a directive which aims to provide for protection from discrimination on grounds of age, disability, sexual orientation

and religion or belief beyond the workplace. The aim of the proposal is to ensure equal treatment in the areas of social protection, including social security and health care, education and access to and supply of goods and services which are commercially available to the public, including housing.

Despite the fact that the Commission had made anti discrimination measures a priority in 2008, in April 2008 it indicated that it intended to scale down its initial plans and present a proposal focusing solely on discrimination on grounds of disability. This turnaround was however met by fierce opposition from the European Parliament and sparked a round of very strong lobbying. Liberal and Green MEPs, supported by the European Parliament's Socialists, pushed very hard for a broad take on anti discrimination measures and earlier this year voted through an

Own Initiative Report prepared by Liberal MEP Elizabeth Lynne, despite strong opposition from the EPP-ED Group.

Given its focus on access to and supply of goods and services, the new proposal includes banking and insurance services in its scope. Significantly, however, the Commission acknowledges that "the use of age or disability by insurers and banks to assess the risk profile of customers does not necessarily represent discrimination: it depends on the product". Indeed, further to a meeting with DG Employment's Services on the 17th of April 2008, the European Banking Industry Committee (EBIC) sent a letter to the Commission dated the 20th of May 2008, in which the Industry stresses that financial institutions do not distinguish between disabled and non-disabled persons, for reasons which are not relevant to the specificities in each particular case. When a consumer is denied a credit, this is always the result of an objective credit decision making procedure, where only the relevant circumstances are taken into account.

Positively, Article 2 of the proposal on the "Concept of Discrimination" provides a special rule for insurance and banking services, "in recognition

of the fact that age and disability can be an essential element of the assessment of risk for certain products, and therefore of price". The proposal goes on to note that "actuarial and risk factors related to disability and to age are used in the provision of insurance, banking and other financial services", and suggests that "these should not be regarded as constituting discrimination where the factors are shown to be key factors for the assessment of risk".

The Commission's proposal has now been transmitted to the Council and the European Parliament according to the consultation procedure, which requires that the Council consult the European Parliament before voting on the Commission proposal and take its views into account (although it is not bound by the Parliament's position). The EMF will continue to monitor the development of this file.

The text of the Proposal can be found at:

http://ec.europa.eu/employment_social/fundamental_rights/org/imass_en.htm#propdir



NEWS IN BRIEF >

> EMF PUBLISHES REVISED VALUATION STUDY

First published in 1998 and again in 2005, the EMF's Study on the Valuation of Property for Lending Purposes has been completely revised in 2007 with a view to providing a deeper understanding of the context and technicalities of valuation practices in the EU. The Study includes a number of new features: The scope has been extended to all issues relevant to the valuation, the valuer & the role of valuation in the CRD; an Executive Summary highlighting the main trends across the EU; a first-time national chapter from the Czech Republic; a chapter on Independence of the Valuer - including a set of EMF Guidelines & the EMF Note on the Independence of the Valuer and finally, a chapter on Automated Valuation Models (AVMs) - including an Article, an EMF Note on the Use of AVMs in the EU & the EMF's Guidelines on AVM Quality Criteria & the Use of AVMs in the EU. The revised Study can be downloaded for free at www.hypo.org.

> ONGOING REVIEW OF DISTANCE MARKETING OF FINANCIAL SERVICES DIRECTIVE

With a view to boosting consumer confidence in the distance marketing of financial services, including mortgage credit), by telephone/fax and particularly via the internet on a cross-border basis, in 2002 the EU adopted a **Directive**, which establishes a set of EU-wide information requirements for financial services sold at a distance and establishes minimum withdrawal periods from distance contracts. On the 6th of April 2006, the Commission adopted a communication which informs the European Parliament and the Council on the state of play regarding the review of the application of this Directive. In this context, the Commission launched two studies in January 2007 to analyse the impact of the Directive on the distance selling of financial services between suppliers and consumers within the internal market. The first study, which is intended to provide the legal input into the analysis of the Directive was completed at the end of June 2008, while the second, economic study, is due to be finalised at the end of August 2008. The results of both of these studies will be reflected in a Commission report which is scheduled for 2009. The European Banking Industry Committee (EBIC), of which the EMF is a member, provided its comments on both studies on the 11th of June 2008 and the 7th of July 2008 respectively and is currently finalising a Position Paper on the draft final report on the legal impact of the Directive. The EMF will continue to follow the developments of this file.

> EQUITY RELEASE STUDY

In the framework of the Commission's Mortgage Credit White Paper, one of the studies currently underway looks at equity release schemes ("ERS") in the EU, particularly with a view to promoting such schemes for old age pension opportunities in the European market. The consultants carrying out this study, IFF, have been given the task of identifying existing schemes, conditions favouring the development of ERS as well as obstacles to their development. In the frame of this research, providers, regulators, governmental organisations, legal experts, notaries and consumer associations are currently being consulted until the 15th of August 2008. After this date, the consultants will present an interim report, to be followed by the final report later in the summer. The EMF has provided input on the questionnaire and is currently consulting internally on this issue.

> IMPACT ASSESSMENT PCI, APRC, EARLY REPAYMENT AND ASSESSMENT OF CREDITWORTHINESS

Regarding the policy options outlined in the White Paper and its accompanying impact assessment for pre-contractual information, the APRC, early repayment and the assessment of creditworthiness, the Commission has committed to a detailed cost-benefit analysis of these issues according to better regulation principles. In view of this objective, a tender had been issued end March 2008, in response to which the Commission had only received one application. A new tender has now been issued for this impact assessment on the 12th of July, the deadline for submitting tenders is mid September 2008.



> **EU RECOMMENDATION ON LAND REGISTRATION, FORECLOSURE AND VALUATION**

In order to address legal infrastructural obstacles to the cross-border provision of mortgage credit, the European Commission is currently carrying out an impact assessment on possible policy options for an EU Recommendation on Land Registration, Foreclosure and Valuation. The EMF has been closely cooperating with the consultant, CSES, throughout the process, and both Legal Affairs and Valuation Committee members have provided direct input on key issues and the different policy options in an exchange with CSES. The draft report is expected for the 25th of July 2008 at the time of writing, and the final report for the 25th of August 2008.

> **CALL FOR CANDIDATES: COMMISSION EXPERT GROUP CREDIT HISTORIES**

As one of the deliverables announced in the European Commission's White Paper on Mortgage Credit, the Commission is currently putting in place an Expert Group on Credit Histories (EGCH). The call for expressions of interest had been published mid-June, the deadline for applications expired on the 14th of July 2008, and the Commission is currently considering the applications before it. The EGCH's mandate is to advise the European Commission on ways to enhance the access to and the exchange of credit data within the EU's single market, by identifying obstacles to access and exchange of credit data, analysing possible impacts of the coexistence of different approaches, and by presenting proposals on how to address the identified obstacles. The EGCH will present its recommendations in the form of a report to be completed by 1 May 2009. A first session of the group, which will be chaired by DG MARKT, is scheduled for September this year.

> **EXPERT GROUP FINANCIAL EDUCATION**

Following its Communication on Financial Education, adopted in parallel with the Mortgage Credit White Paper on the 18th of December 2007, the European Commission had opened a call for applications for the Expert Group on Financial Education (EGFE), to be composed of financial education practitioners. Last year's Communication underlines the Commission's support for the provision of financial education to be delivered as close as possible to citizens, namely through Member State, national and regional authorities, non-governmental agencies and the financial services sector. The new Expert Group will unite experts representing both private and public stakeholders, i.e. national authorities, the financial industry, consumer associations, and academia. It aims at promoting the exchange of ideas, experiences and best practices, and will advise the Commission on its policy-making in the area of financial education. The EMF has responded to the call for expressions of interest, which had been closed on the 13th of June 2008, and the Commission is now expected to announce appointments mid-August 2008.

> **CONSUMER ACQUIS FOLLOW-UP: HORIZONTAL REGULATION ON CONSUMER CONTRACTS**

Following a Green Paper on the Revision of the Consumer Acquis in summer 2007, looking at the identification of general issues arising in the context of consumer contracts potentially of common concern across the sectors, the European Commission is now in the process of drafting a horizontal framework directive on consumer contracts. The process is led by DG SANCO, and the main concerns are cutting compliance cost for business resulting from a fragmented Consumer Acquis, at the same time as ensuring access for consumers to competitive cross-border products and services. The proposal for a Directive seeks to achieve this by revising and merging into a single instrument the Doorstep Selling Directive, the Unfair Terms Directive, the Distance Selling Directive, and the Consumer Sales and Guarantees Directive. For financial services contracts, exemptions apply from the Directive's rules on codes of conduct, enforcement, penalties, prohibition on waivers by consumers, and information obligations regarding codes of conduct. In inter-service consultation at the time of writing, the next step for the dossier will be the adoption by the College of Commissioners.

> **DG COMPETITION WHITE PAPER ON DAMAGES ACTIONS/ COLLECTIVE REDRESS**

As a complement to DG SANCO's initiative on collective redress benchmarks, DG COMPETITION has now issued a White Paper on damages actions, on which it had been consulting until the 15th of July 2008. The paper addresses the standing of parties to the procedure (opt-in vs. opt-out), the question of "qualified entities" who have the authority to represent victims of competition law infringements, procedural questions such as access to evidence and the binding effect of NCA decisions, limitation periods, costs and the interaction with leniency programs. Following the EMF response to DG SANCO's initiative on collective redress benchmarks, the EMF's Legal Affairs Committee has consulted on this question, and stakeholder responses are expected to be published by DG COMPETITION over the summer.



AGENDA

S E P T E M B E R

04 > 05/09	Vdp Roundtable, Berlin
23/09	ECBC Steering committee, Paris
24/09	ECBC Plenary Meeting, Paris
25/09	ECBC / EUROMONEY Conference, Paris
26/09	EMF Statistic Committee, Stockholm
29/09	27 th IUHF World Congress 2008, Sun City, South Africa



MORTGAGE CREDIT AT A CROSSROADS

Beyond the crisis



EMF Annual Conference 2008
20 & 21 November 2008 | BRUSSELS

www.emfconference.org