

STUDY

Requested by the ECON committee



Mortgage Credit

Mis-selling of Financial Products



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Mis-selling of Financial Products: Mortgage Credit

STUDY

Abstract

This paper forms part of a series of five studies on mis-selling of financial products in the EU. The mis-selling of mortgage loans that include floor clauses, foreign currencies (forex) clauses and related products is the subject of this research. We analyse the context, the handling of the problem in the most affected Member States (Croatia, Hungary, Poland, Romania and Spain) and its compatibility with EU law. We conclude with recommendations. This document was provided by Policy Department A at the request of the ECON Committee.

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LIST OF ABBREVIATIONS

- AEB** Asociación Española de Banca (Spanish Banking Association)
- APRC** Annual Percentage Rate of Charge
- CCD** Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 on credit agreements for consumers (*'Consumer Credit Directive'*)
- CEEC** Central and Eastern European Countries
- CFREU** Charter of Fundamental Rights of the European Union
- CHF** Swiss franc
- CGPJ** Consejo General del Poder Judicial (General Council of the Judiciary, Spain)
- CJEU** Court of Justice of the European Union
- CNMV** Comisión Nacional del Mercado de Valores (National Securities Market Commission, Spain)
- DTI** Debt-to-income-ratio
- EBA** European Banking Authority
- ECB** European Central Bank
- ES** Spain
- ESAs** European Supervisory Authorities
- ESMA** European Securities and Markets Authority
- ESRB** European Systemic Risk Board
- EU** European Union
- FCA** Financial Conduct Authority (UK)
- FIN-USE** Expert Forum of Financial Services Users
- FSB** Financial Stability Board
- FSC** Financial Stability Committee (Poland)
- HNB** Croatian National Bank
- HR** Croatia
- IMF** International Monetary Fund
- HU** Hungary
- IRPH** Índice de Referencia de Préstamos Hipotecarios (Mortgage Loan Reference Index)

- LTI** Loan-to-income
- LTV** Loan-to-value
- MCD** Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010 (*'Mortgage Credit Directive'*)
- MCD Proposal** Proposal for a Directive on credit agreements relating to residential property, 31 March 2011 [COM(2011) 142]
- NACP** National Authority for Consumers Protection (Romania)
- NBR** National Bank of Romania
- OCCP** Office of Competition and Consumer Protection (Poland)
- PL** Poland
- RO** Romania

EXECUTIVE SUMMARY

Mortgage credit is an essential part of the financial market. It makes it easier for consumers to purchase homes. It requires regulations that protect both the stability of lending institutions and consumers' rights in view of the risk of overindebtedness. Consumers are entitled to know the conditions they are signing and to be warned of the risks. The system must take account of the right to housing and the protection of the health of consumers affected by mis-selling of mortgage loans. Self-regulation by lending institutions is insufficient to achieve these objectives. Regulation of this sector is justified. In the European Union, the Mortgage Credit Directive (MCD) of 2014 aims to protect consumers by preventing irresponsible lending. Within this framework, the European Banking Authority (EBA) has defined creditworthiness assessment guidelines in line with the Financial Stability Board (FSB)¹. Regulation is not sufficient in itself. Effective protection of consumers must be achieved and to do that it is necessary for the financial authorities to guide institutions' behaviour in accordance with the principles established in the MCD.

Cases

- **Foreign currency loans.** The mortgage credit market is characterised by its dynamism. Foreign currency loans are an alternative that became common prior to the financial crisis in several Central and Eastern European Countries (CEEC). Consumers benefitted from paying less interest than they would have to pay on financing in local currency. However, they took out the loans without being aware of the risk of the currency they received their income in being devalued while their mortgage obligations in the foreign currency remained the same. In this context, households' overindebtedness *'became a major social problem, which resulted in a strong deterioration of the confidence in the financial intermediary system'*². Loans were marketed without suitable assessment of creditworthiness and without warning of the risks in a manner comprehensible to the consumer. The lack of EU regulation may have contributed to mis-selling. When the ESRB detected the problem in 2011, it recommended the adoption of measures to manage the systemic risk and protect consumers. It was its first warning of systemic risk. The response to prevent mis-selling once again came in the form of a directive. The MCD establishes the right to convert the loan agreement into an alternative currency. However, it expressly prohibits its retroactive application. It became necessary to introduce measures to help the most vulnerable consumers.
- **Floor rate clauses.** When the financial crisis struck, some financial institutions added floor rate clauses to their mortgage loan agreements, which set a lower limit on interest rates. This guaranteed a return to hedge themselves from the impact that the financial crisis could have on their margins. Spain was where the mis-selling of mortgage loans with floor rate clauses was most widespread. One third of loans sold in 2010 included floor rate clauses. This is a mass fraud that has given rise to more than a million applications for the return of amounts unduly charged by the banks. In spite of the fact that this is a case of mis-selling of systemic importance with thousands of court judgments to support it, no penalties have been imposed on financial institutions. According to the IMF, the Bank of Spain *'has been slow in imposing monetary fines'*³. There is no deterrence of mis-selling. The bill to incorporate the MCD into Spanish law has been drafted with the main aim of achieving legal certainty in mortgage contracting

¹ See EBA, *Guidelines on creditworthiness assessment* (2015).

² Cyman (2017), p. 456.

³ See IMF (2017), paragraph 155, p. 50.

and with the side effect of providing a safe harbour for the banks in view of the stream of complaints from consumers. While this aim is praiseworthy, it must be achieved together with appropriate consumer protection. The EBA must ensure there is supervisory convergence in Spain and other Member States to achieve correct application of the rules of conduct in the mortgage credit market.

Conclusions

Several conclusions can be drawn from our analysis of the main cases of mis-selling. Banks should prioritise their customers' interests in the sale of mortgage loans. Conflicts of interest must be identified and managed. In turn, customers must be aware of the cognitive biases that affect their decisions. It would be good for consumers to receive financial education and know their own limitations. There are cases of opportunism by financial institutions that take advantage of their customers' cognitive biases. For instance, highlighting the initial advantages without warning of the risks when marketing mortgage loans. It is up to supervisors to investigate such mis-selling in order to alert the people affected. The MCD is a suitable framework for consumer protection but lacks the desired effectiveness. The case law of the Court of Justice of the EU (CJEU) is having a determinant effect on redressing the harm caused by mis-selling of mortgage loans, in particular through the inclusion of floor rate and foreign currency clauses. Groups of affected consumers are disseminating its judgments, which are contributing to increasingly harmonised development of financial consumer law. This development strengthens consumer confidence in the banking system. It also provides legal certainty for the benefit of consumers and financial institutions. The retroactive application of measures to protect consumers who are overindebted as a consequence of mis-selling must be justified on the basis of defending the most vulnerable and must have eligibility requirements.

Recommendations

The recent incorporation of the MCD into national law makes prudence advisable when assessing it. Its principles must be concretised by regulatory and non-regulatory documents issued by the European financial authorities⁴. At the moment, the problem is not a lack of rules but rather achieving harmonised interpretation of the rules and effective enforcement. Until the MCD is revised in March 2019, efforts must be focused on setting standards of conduct for institutions in accordance with their business obligations to act '*honestly, fairly, transparently and professionally, taking account of the rights and interests of the consumers*'⁵. The criteria set by ESMA in accordance with the MiFID II could be taken as a reference in applying these principles. Guidelines should be issued concerning the knowledge and competence of employees who inform and advise on mortgage loans. It would also be appropriate to issue guidelines on early repayment of mortgage loans and guidelines specifying when bad practices must be published by supervisors.

- **Financial education** can only play a supplementary role to rules of conduct.
- It is questionable whether a single financial authority can take on the objectives of protecting both consumers and institutions' stability. Therefore, the **twin peaks** model is recommended. In this model, supervisory tasks are divided between a prudential authority that protects stability and a conduct authority aimed at consumer protection.

⁴ ECB and ESAs.

⁵ Article 7.1 MCD.

- **Incentives for good conduct must be created.** The penalties must act as a deterrent. It must be easier to file class actions⁶. The costs arising from mis-selling should be borne by the institutions that cause it. At the moment, in the absence of effective class actions, out-of-court procedures are a more effective way of handling claims that affect thousands of consumers. This is also a more appropriate channel from the viewpoint of financial institutions' stability. It allows them to identify the problem, agree on how to redress it and restore customer confidence more quickly. Lengthy court disputes tarnish the reputation of financial institutions. When the financial authorities detect a case of mass mis-selling, they should take the initiative to set up an *ad hoc* system to speed up compensation.

⁶ See European Commission, *A New Deal for Consumers: Commission strengthens EU consumer rights and enforcement*, Brussels, 11 April 2018. Available at: http://europa.eu/rapid/press-release_IP-18-3041_en.htm.

1. BACKGROUND

The purpose of this part is to investigate the mis-selling of mortgage loans with foreign currency (forex) clauses, with floor clauses and related products.

When it examined the financial crisis in 2011, the European Parliament deemed that the **banks bear their share of responsibility for the irresponsible lending**⁷. Several petitions⁸ have been received regarding the marketing of mortgage loans with floor or multicurrency clauses that may have been abusive. In fact, according to consumer surveys, the worst performing financial services markets in the EU are those related to 'real estate services' and 'mortgages'⁹.

The scope of this research is not mortgages per se but rather mortgage credits and mis-selling in the marketing of them. A mortgage credit is a **loan with real estate as collateral within a private-law framework**. The problem of mis-selling does not arise from the property being provided as collateral but rather from the incorrect marketing of the financial product. We use the term '*mis-selling*' in a broad sense, comprising practices that are detrimental to customers with or without illegal behaviour¹⁰.

The problem of foreign currency loans has been significant in Central and Eastern European countries (CEEC), notably Croatia, Hungary, Poland and Romania, although it has also arisen in Spain, the country in which the problem of floor rate clauses has been most intense. Floor rate clauses prevent borrowers with variable rate mortgages from benefiting from a fall in interest rates.

Against this background, this report will look at the causes of complaints and petitions made to the European Parliament in view of the existing EU regulation on business conduct of financial institutions when they offer mortgages and related products, including cross-currencies and floor clauses. In accordance with our mandate, the report will focus on the following questions:

- How could prospective recommendations on potential policy measures ensure both compensation of damage suffered by consumers and a higher level of consumer protection?
- How have issues in mortgage credit in foreign currencies (forex) been addressed in Croatia, Hungary, Poland, Romania and Spain? Are there issues regarding compliance with the EU law in these countries?
- Does the Spanish Royal Decree-Law 1/2017 (which establishes out-of-court resolution for the floor rate clause cases) fully enforce EU legislation?

⁷ European Parliament resolution of 6 July 2011 on the financial, economic and social crisis: recommendations concerning the measures and initiatives to be taken [2010/2242(INI)], which states the following: '*parent banks originating in Member States also bear their share of responsibility for the irresponsible lending practices engaged in by their subsidiary banks in other EU Member States, which contributed inter alia to the real-estate bubbles in Spain, Ireland and Latvia*'.

⁸ For instance, see petitions to the European Parliament No. 0513/2012, 1249/2013, 2206/2013, 2215/2013, 2228/2013, 2637/2013, 2563/2013, 0114/2014, 0598/2016, 0644/2016 and 0175/2017.

⁹ Consumer Markets Scoreboard: Making markets work for consumers' (2016), p. 18 (Chapter III: Consumers' assessment of market performance).

¹⁰ The use of the term '*mis-selling*' is controversial for the Croatian National Bank (HNB), which sees it as referring not solely to practices that are expressly unlawful, but also considered unethical by consumers or dubious from a legal perspective. *Response to Research Questionnaire*, HNB, 15 February 2018, p. 1.

2. MORTGAGE CREDIT FRAMEWORK

KEY FINDINGS

- The regulation of mortgage loans is aimed at protecting the stability of financial institutions and protecting consumers, as complementary objectives.
- It is a system that takes account of the right to housing and the protection of the health.

2.1. Mortgage credit and the right to housing

Mortgage credit, in particular when the mortgage is for the debtor's habitual residence, **affects the fundamental right to housing**. The United Nations Economic and Social Council prioritises the right to housing over the lender's right to enforce the mortgage loan agreement as agreed¹¹. When assessing the conduct of banks that market and manage mortgage loans, case law¹² explicitly or implicitly considers the extent to which the right to housing is affected¹³. CJEU judgments are having an *'immense social impact, which ultimately consolidates the perception of EU consumer law as an expression of the protection of individual fundamental rights and principles'*¹⁴. Just like derivatives, housing finance *'is politically sensitive'*¹⁵ since it triggered the financial crisis.

2.2. Mortgage credit and financial stability

Mortgage credit is an essential operation for banks' stability, not only due to its **importance for their balance sheets**¹⁶ but also because it establishes a **long-term relationship with the consumer** and allows the banks to offer them combined products such as payment services, insurance and other hedging. This can make mortgage credit essential for the stability of a bank.

One should recall that the financial crisis originated with subprime mortgages granted in the United States. In many cases, these mortgages were granted by institutions in order to sell them through complex asset securitisation chains. Risks and lawsuits arising from

¹¹ See the I.D.G. v Spain case, UN Committee on Economic, Social and Cultural Rights, of 28 January 2014, in relation to procedural rights in response to an enforcement application due to non-payment of several instalments of a mortgage loan. After recalling that *'the human right to adequate housing is a fundamental right central to the enjoyment of all economic, social and cultural rights'* and that *'the right to housing should be ensured to all persons irrespective of income or access to economic resources'*, the Committee concluded that the Spanish state had an obligation to *'ensure that the auction of the author's property does not proceed unless she has due procedural protection and due process'*.

¹² The CJEU Judgment in case C-415/11, Mohamed Aziz v Caixa d'Estalvis de Catalunya, Tarragona i Manresa (Catalunyacaixa) of 14 March 2013, regarded Spanish legislation on enforcement in respect of mortgaged property not to comply with the principle of effectiveness and to be contrary to Directive 93/13. Commented on by Micklitz (2013), followed by Cherednychenko (2017), p. 159, according to whom *'The court's reasoning appears to suggest that the consumer's interest in preserving his home, which is protected by the fundamental right to home, has been absorbed in the well-established effectiveness test in EU law and has ultimately influenced its outcome'*. Similarly, Iglesias Sánchez (2014), p. 970; and Barral-Viñals (2015).

¹³ Cherednychenko (2017).

¹⁴ Iglesias Sánchez (2014), p. 974.

¹⁵ Goodhart (2017), p. 239.

¹⁶ Non-performing loans (NPL) ratios in Member States as of December 2016 are at high level in HR and RO, and at relatively low level, after a significant increase during the crisis, in ES, HU and PL. Briefing 'Non-performing loans in the Banking Union: state of play', 13 July 2017, available at [http://www.europarl.europa.eu/RegData/etudes/BRIE/2017/602072/IPOL_BRI\(2017\)602072_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/BRIE/2017/602072/IPOL_BRI(2017)602072_EN.pdf), although there are no specific data about the proportion of non-performing mortgage loans in those countries. *'Data from the US suggests that the servicing of non-performing mortgage loans costs about 13 times more than that of performing loans'*, European Commission (2018), Box A.5.3, p. 123, see note 136.

mortgage credit can be of systemic importance. This was the view taken by the ESRB, which devoted its first recommendation to lending in foreign currencies¹⁷, in particular lending in the form of mortgage credit.

2.3. Mortgage credit and consumer protection

In the mortgage credit market, contractual agreements are predominantly pre-defined by the banks. Such pre-defined general terms and conditions must be clear and comprehensible, so that the consumer can take informed decisions with full knowledge of the facts. The main risks that consumers must be warned about when marketing mortgage loans are interest rate risk in variable rate loans and exchange risk in multicurrency loans. When hedging products such as swaps are offered, it is necessary to clearly warn of the specific risks of these financial derivatives. Information must be clear and understandable. There are products that *'due to their complexity and lack of transparency'* are not suitable for the consumer¹⁸.

Mortgage credit can result in detriment to consumers and to financial stability, for example, the detriment caused by consumers' inability to meet their obligations under the credit agreements¹⁹. Assessing creditworthiness is an essential aspect in preventing overindebtedness and protecting consumers. Prior to the financial crisis, it was common in some markets to grant mortgage loans without carrying out such an assessment or by asking customers to self-certify their income²⁰.

2.4. Mis-selling and health

Consumer overindebtedness, the cause of which is irresponsible lending, causes stress²¹ with resulting health problems²². There are studies that have demonstrated that **there are health effects arising from the mis-selling of financial products**²³. *'Victims of financial fraud have worse health and worse living standards than other people of their age.'*²⁴ The associations that represent them regard this as being the case²⁵. In particular, customers adversely affected by taking out mortgages in foreign currency have serious health problems²⁶.

¹⁷ ESRB (2011).

¹⁸ See ESMA (2018).

¹⁹ EBA, *Guidelines on creditworthiness assessment* (2015), p. 4.

²⁰ EBA, *Opinion of the European Banking Authority on good practices for mortgage creditworthiness assessments and arrears and foreclosure, including expected mortgage payment difficulties* (2015), p. 4. See also FCA (2016).

²¹ European Commission (2008), p. 37, which describes this psychological aspect of overindebtedness *'in terms of the severe stress and psychological destabilization overindebtedness can bring forth for the affected persons'*; in World Bank (2013), p. 6.

²² Vásquez-Vera, Palència, Magna, Mena, Neira, Borrell (2017), pp. 199-208. Bolívar (2016), pp. 4-10.

²³ Zunzunegui, M. V., et al. (2016). Ganzini, McFarland and Cutler (1990), pp. 680-685.

²⁴ Xesús Domínguez from Coordinator of Platforms for those Affected by Preference Shares during his appearance before the Committee investigating the financial crisis in Spain and the financial aid programme. Available at: http://www.congreso.es/wc/htdocs/web/jsp/canalParlamento/reproductorDirectoAkamai/player_diferidomp4.js?p?codSesion=22&codOrgano=360&mp4=mp4&directo=s&fechaSesion=16%20de%20Enero%20de%202018&iLegislaturaElegida=12 (1:14:25 and following).

²⁵ Response to Research Questionnaire from ASUFIN, 29 January 2018, p. 4; and Plataforma de Afectados por la Hipoteca - PAH Madrid, 14 February 2018, pp. 2 and 3.

²⁶ Zunzunegui, M. V., et al. (2016). Other conclusions were reached in Poland, using a disputable methodology: Białowolski and Węziak-Białowolska (2017). Statistical methods seem adequate, but the design of this study has one major flaw and one potential measurement problem. The time of data collection in 2015 seems to overlap with the oscillations in the exchange value of the Swiss francs along 2015, with no time for the exposure (stress from abusive mortgage) to act on the body's systems. Concerning the measurement problem, the validity of one of the three chosen health indicators is unknown (health satisfaction).

3. EU MORTGAGE CREDIT LAW

KEY FINDINGS

- Self-regulation is insufficient to protect the consumers and the stability of financial institutions.
- MCD aims to protect consumers by preventing irresponsible lending.

3.1. Background

There have been two stages in establishing EU standards regarding mortgage lending. There was an initial self-regulation stage through the European Commission Recommendation of 1 March 2001 and a more recent regulatory stage through the Mortgage Credit Directive of 2014.

The Commission Recommendation of 1 March 2001 on pre-contractual information was the first measure adopted in the EU to protect consumers who take out home loans²⁷. According to recital one of said Recommendation: *'Signing a home loan contract is often the most important financial commitment that a consumer enters into.'*²⁸ The emphasis is placed on pre-contractual information. This includes, for the first time, a 'European Standardised Information Sheet', with details of how the interest rate will vary²⁹. It is the result of three years of negotiations between representatives of the banks and consumers³⁰, which gave rise to a **Voluntary Code of Conduct on pre-contractual information for home loans** (the 'Code'), that institutions can sign up to³¹. According to the follow-up reports, there was widespread acceptance, though, as a sole exception, no Spanish bank signed up to the Code³².

In the Green Paper on Mortgage Credit in the EU from July 2005, the European Commission acknowledged that *'Mortgage credit markets are amongst the most complex markets in which consumers engage'*³³. The appearance of innovative products should be accompanied *'with a high level of consumer protection'*³⁴. It asked the question of whether the Code of Conduct ought to be replaced with binding legislation.

In December 2007, the White Paper on the Integration of EU Mortgage Credit Markets sought to increase *'the diversity of products, improve consumer confidence and promote customer mobility'*³⁵. With these aims in mind, it deemed that mortgage lenders *'should be required to adequately assess, by all appropriate means, borrowers' creditworthiness before granting them a mortgage loan'*. Protecting consumers by providing them with

²⁷ Commission Recommendation of 1 March 2001 on pre-contractual information to be given to consumers by lenders offering home loans [notified under document number C (2001) 477] (2001/193/EC).

²⁸ This expression is repeatedly used by the European Commission (2007), p. 2; and the EBA, *Guidelines on creditworthiness assessment* (2015), p. 4.

²⁹ Commission Recommendation of 1 March 2001 on pre-contractual information to be given to consumers by lenders offering home loans, Annex II, 3.

³⁰ European Commission (2001), that *'will be the real test of the efficiency of self-regulatory instruments'*.

³¹ Available at: http://ec.europa.eu/internal_market/finances-retail/docs/home-loans/agreement_en.pdf.

³² *'Spain is the only country, where credit institutions have not registered yet'*, 'European Agreement on a Voluntary Code of Conduct on Pre-contractual information for Home Loans. First Annual Progress Report on Implementation in the European Union (2002)', p. 5. According to the Third Progress Report (2009), p. 8: *'In Spain, a regulation to enforce the Code and resolve the problem of incompatibility between the Code and the national legislation is required.'*

³³ Commission of the European Communities, *Green Paper on Mortgage Credit in the EU*, Brussels, 19 July 2005 [COM (2005) 327 final], p. 4.

³⁴ Commission of the European Communities (2005), pp. 5-6.

³⁵ European Commission (2007), p. 3.

information and assessing their creditworthiness³⁶ became a key part of the legislative agenda after the priority to integrate the mortgage market in the EU³⁷. However, the Commission did not consider it appropriate to propose a directive to regulate the mortgage market due to *'the political sensitivity of this issue, and the complexity of finding an appropriate level of harmonisation'*³⁸. The Consumer Credit Directive from 2008 left mortgage lending outside of its scope³⁹ as it required a different approach.

In December 2008, FIN-USE, the first group established of financial services experts from the users' perspective, warned the European Commission that *'irresponsible lending and some unscrupulous practices were not effectively controlled'*⁴⁰. It concluded that self-regulation is not sufficient and that *'radical measures such as national mortgage rescue schemes are needed to ensure people do not lose their homes'*.

3.2. Mortgage Credit Directive

Seven years after the financial crisis began, the Mortgage Credit Directive of 4 February 2014 established professional standards for mortgage lending in the EU for the first time. It aims to protect consumers by **preventing irresponsible lending** that jeopardises financial stability. It does so by stipulating obligations to inform and assess the creditworthiness of consumers with enhanced requirements when there are complexities such as floor rate clauses or foreign currency mortgages. It is a flexible and open framework with minimal harmonisation, allowing Member States to enhance the level of protection provided. There is only maximum harmonisation in the European Standardised Information Sheet (ESIS) and the calculation of the annual percentage rate of charge (APRC)⁴¹.

The legislative procedure started with the ambitious proposal of the Directive of the European Commission of 31 March 2011⁴². Regarding the key question of creditworthiness assessment, the duty to refrain from lending when there is a negative assessment was watered down. The duty on banks to *'identify products that are not unsuitable for the consumer given his needs, financial situation and personal circumstances'*⁴³ could not find a majority. A commitment was thus made⁴⁴ to establish, for the first time in the EU, standards to achieve responsible granting of mortgage loans with assessment of consumer solvency and special obligations for mortgage loans with floor rate or foreign currency clauses. This protection is compatible with the aim to preserve the stability and competitiveness of financial institutions.

³⁶ European Commission (2007), point 3.3.

³⁷ See European Commission, *White Paper on the Integration of EU Mortgage Credit Markets – Frequently Asked Questions (FAQs)* (2007).

³⁸ European Commission, *White Paper on the Integration of EU Mortgage Credit Markets – Frequently Asked Questions (FAQs)* (2007).

³⁹ See article 2.2.a) of Consumer Credit Directive (CCD).

⁴⁰ FIN-USE (2008).

⁴¹ 'Annual percentage rate of charge' (APRC) means the total cost of the credit to the consumer, expressed as an annual percentage of the total amount of credit, where applicable, including the costs referred to in Article 17(2) and equates, on an annual basis, to the present value of all future or existing commitments (drawdowns, repayments and charges) agreed by the creditor and the consumer [Article 4 (15) MCD].

⁴² European Commission (2011).

⁴³ Article 14.4 of the Proposal for a Directive on credit agreements relating to residential property, Brussels, 31 March 2011 [COM (2011) 142 final 2011/0062 (COD)].

⁴⁴ Kastner (2017), pp. 8-10.

The EBA has defined good practices for mortgage credit, addressing the assessment of creditworthiness in the wider context of responsible mortgage lending in accordance with the FSB Principles⁴⁵.

As far as measures to incorporate the MCD into national law are concerned, there is a contrast between the many measures introduced by Member States in Central and Eastern⁴⁶ Europe referred to in this study and the delay by some Member States that have not adopted any measures. Application of the directive certainly must be flexible. Member States have a certain discretion of how to transpose a directive into national law. As the EBA has said, '*Considering the distinct real estate markets, cultural differences and socioeconomic policies that shape each national mortgage market, the applicability, effectiveness and appropriateness of the good practices may vary across EU markets.*'⁴⁷. However, national diversity must not result in an obstacle to consumer protection.

⁴⁵ EBA, *Opinion of the European Banking Authority on good practices for mortgage creditworthiness assessments and arrears and foreclosure, including expected mortgage payment difficulties* (2015), paragraph 12, p. 3.

⁴⁶ Croatia (6), Hungary (26), Poland (19), Romania (9), Spain (0), available at: <http://eur-lex.europa.eu/legal-content/ES/NIM/?uri=celex:32014L0017> [last visit 11 April 2018].

⁴⁷ EBA, *Opinion of the European Banking Authority on good practices for mortgage creditworthiness assessments and arrears and foreclosure, including expected mortgage payment difficulties* (2015), paragraph 12, p. 3.

4. THE CASE OF FOREIGN CURRENCY LOANS

KEY FINDINGS

- Borrowing in foreign currencies became a major social problem in several Central and Eastern European Countries (CEEC).
- MCD establishes the right to convert the credit agreement into an alternative currency.

4.1. General aspects

Prior to the global financial crisis, borrowing in foreign currencies by households became common in several CEEC⁴⁸. In these countries, the need for home financing under affordable conditions was met by euro area banks with loans in foreign currency⁴⁹. Based on the commercial strategy followed by each of these banks, the offers highlighted the advantages of better interest rate conditions⁵⁰ with a strong and stable currency. It was expected that the domestic currency in which borrowers received their income would appreciate in the future as soon as these Member States joined the euro⁵¹. These expectations were not met; in fact, the opposite took place. When the foreign currency in which loans were issued appreciated, borrowers got into difficulty meeting mortgage repayment obligations⁵². They had not been warned of this risk when the product was sold to them. The problem came to the spotlight after the decision of the Swiss National Bank to stop the fixed exchange rate with the euro and the subsequent appreciation of the CHF vis-a-vis other currencies (especially non-euro CEEC), thereby exposing the exchange rate risks inherent to the foreign currency loans⁵³.

Foreign currency loans are **complex products. They are difficult for consumers to understand**⁵⁴. They have cognitive biases which financial institutions may have exploited in their marketing campaigns for these kinds of products⁵⁵. Apparently, households fall for an *'exchange rate illusion'*⁵⁶. Before consumers took out these kinds of loans, they should have been warned that in addition to the interest rate risk, they also faced an exchange rate risk. The European Central Bank (ECB) warned in 2010 of the *'malign riskiness of foreign currency loans'*⁵⁷ and concluded that *'broadly coordinated action involving home country supervisors is needed'*⁵⁸.

In 2011, ESRB deemed that **excessive foreign currency lending to unhedged borrowers may produce significant systemic risks** in number of EU Member States such as Hungary, Poland and Romania and may create conditions for negative cross-border

⁴⁸ ECB, Opinion CON/2015/32, p. 3, referring to the data in the Annex to ESRB (2011).

⁴⁹ ECB (2010), p. 162.

⁵⁰ See ECB, Opinion CON/2015/32, p. 3. See Response to Research Questionnaire, HNB, 15 February 2018, pp. 4 and 5.

⁵¹ See ECB (2010), p. 162.

⁵² ECB (2010), p. 163.

⁵³ On 15 January 2015, the SNB removed the 1.2 EUR/CHF floor, which led to the immediate and significant appreciation of the CHF against the euro. See NBR (2015), pp. 9-12.

⁵⁴ See Cyman (2017), p. 458.

⁵⁵ See Finance Watch response to third ESAs Joint Committee's consultation on PRIIPs (Draft Regulatory Technical Standards), 29 January 2016, p. 5; Cyman (2017), p. 457.

⁵⁶ Buchen, et al. (2016), p. 12.

⁵⁷ ECB (2010), p. 163, note 6 (emphasis added). Countries with a floating exchange rate such as Hungary, Romania and Poland suffered a depreciation that made foreign currency loans unaffordable to households, according to Fiorante (2011), p. 4.

⁵⁸ ECB (2010), p. 167.

spillover effects⁵⁹. In this context, '*addressing asymmetric information between borrowers and lenders may lessen financial stability concerns.*'⁶⁰. In order to tackle this problem, the ESRB had issued recommendations that include risk awareness of borrowers and creditworthiness assessment⁶¹ as the most effective measures to reconcile the objectives of banking stability and consumer protection. It takes the view that loan-to-value (LTV) ratios protect banks from excessive risk-taking and that debt-to-income (DTI) ratios protect borrowers from overindebtedness⁶².

According to the ESRB, there is no one-size-fits-all-solution. National diversity must be taken into account⁶³. It is necessary to consider the principle of proportionality, except in relation to consumer information. National supervisory authorities and Member States had an obligation to communicate to the ESRB the action taken or adequate justification in the case of inaction by 31 December 2012, under the ***comply or explain principle***. As part of its monitoring and assessment work, the ESRB published a Follow-up Report in 2013⁶⁴. The assessment was based on own submissions. All, except one Member State, were fully or largely compliant, including Hungary, Poland, Romania and Spain⁶⁵.

According to the ESRB risk dashboard⁶⁶, countries featuring a large stock of loans in foreign currency are most at risk, particularly if loans in foreign currency have been extended to unhedged borrowers, with no income in the currency of denomination of the debt, typically private households.

The ESRB is focused on achieving a **balance between consumer protection and banking stability**. The ECB, which in this context focuses more on protecting financial stability⁶⁷, took the view in 2010 that promoting creditworthiness assessment of borrowers by financial institutions is a more effective measure than monetary policy measures or prudential tools⁶⁸. Section 7 of EBA's Draft Guidelines on Creditworthiness Assessment⁶⁹ considers that creditor banks should identify the groups of loans with a higher risk profile, which include foreign currency loans or variable rate loans with floor rate clauses, in order to take them into account when assessing consumers' creditworthiness. However, after public consultation, the EBA decided to remove this section from the guide⁷⁰ on the basis that '*Given that Guideline 7.1 has more of a prudential focus, the EBA has deleted this guideline*'. It thus took into account the comments made by the Polish Bank Association⁷¹ and the European Banking Federation⁷². By removing this article, the EBA Guide diverted

⁵⁹ ESRB (2011), p. 1, and note 3, p. 9.

⁶⁰ ESRB (2011), paragraph (5), p. 1.

⁶¹ ESRB (2011), paragraph (6), p. 1.

⁶² ESRB (2011), pp. 30 and 35.

⁶³ See EBA, *Opinion of the European Banking Authority on good practices for mortgage creditworthiness assessments and arrears and foreclosure, including expected mortgage payment difficulties* (2015), p. 3.

⁶⁴ ESRB (2013).

⁶⁵ Croatia was not included in the assessment.

⁶⁶ ESRB (2017).

⁶⁷ ECB, Opinion CON/2015/56, p. 5, citing, in note 13, Opinion CON/2015/32. Regarding foreign currency loans in Hungary, see also Opinions CON/2011/87, CON/2012/27, CON/2014/59, CON/2014/72 and CON/2014/76 and, regarding foreign currency loans in Poland, Opinion CON/2015/26.

⁶⁸ ECB (2010), p. 166.

⁶⁹ EBA (2014).

⁷⁰ EBA (2015).

⁷¹ Response available at: <https://www.eba.europa.eu/regulation-and-policy/consumer-protection-and-financial-innovation/guidelines-on-creditworthiness-assessment/-/regulatory-activity/consultation-paper>.

⁷² Response available at: <https://www.eba.europa.eu/regulation-and-policy/consumer-protection-and-financial-innovation/guidelines-on-creditworthiness-assessment/-/regulatory-activity/consultation-paper>.

from the FSB Principles for Sound Residential Mortgage Underwriting Practices, which it says was its inspiration⁷³.

4.2. Croatia

One third of housing loans in Croatia are in CHF⁷⁴. This accounts for 9% of banks' total loan portfolios and around 4% of Croatian households⁷⁵. 90% of these loans were granted between 2005 and 2007⁷⁶. *'There is a wide range of customers. More vulnerable borrowers require urgent help that may require partial discharges'*⁷⁷. In 2012, a class-action was brought against eight large banks considered to have included unfair terms in relation to variable interest rates and to foreign currency clauses in their loans⁷⁸.

The Croatian National Bank (HNB) has been using a variety of measures since 2003 to slow credit growth in foreign currencies and tackle household overindebtedness, but success has been modest *'due to the fact that banks did not take account of the regulations'*⁷⁹. In 2011, the authorities and the banks carried out a restructuring with repayment of loans at a fixed exchange rate and the possibility of transferring debt to the later years of maturity, but with very little success.

In January 2014, the Consumer Credit Act was amended to set caps on interest rates in CHF-linked loans. In January 2015, this law was again amended to temporarily fix the Swiss franc exchange rate against the Croatian currency for a one-year term for loan repayments. It was amended again in September that year **to allow consumers to convert their loans into euros**⁸⁰. In March 2016, 94 % of borrowers had exercised their conversion right. 2 458 complaints have been made, mainly concerning documentation issues and conversion calculations. An appeal claiming that the amendment was unconstitutional was rejected. Formal notice has also been given by the European Commission concerning the retroactive effect of placing the cost on creditor banks, affecting legal certainty and going beyond what was necessary and proportionate to protect consumers and the public interest. Meanwhile, the affected banks have initiated arbitration proceedings against the Republic of Croatia.

It is a retroactive measure that has been criticised as it creates legal uncertainty⁸¹ and moral hazard, since it incentivises borrowers to be less cautious in the future⁸². It is also a measure that can be considered to infringe Article 23(5) of the MCD, which prohibits the adoption of other provisions on lending in foreign currency with retroactive effect⁸³.

4.3. Hungary

Between 2004 and 2010, Hungarian households became overindebted with loans in foreign currencies⁸⁴, mainly in CHF. They were marketed as cheap loans, but borrowers'

⁷³ See FSB (2012), section 2.3.

⁷⁴ ECB Opinion CON/2015/32, p. 3-4.

⁷⁵ HNB (2015), p. 5.

⁷⁶ Response to Research Questionnaire, HNB, 15 February 2018, p. 4.

⁷⁷ HNB (2015), p. 5.

⁷⁸ See Response to Research Questionnaire, HNB, 15 February 2018, pp. 5 to 7.

⁷⁹ Buchen, et al. (2016), p. 12 to 15.

⁸⁰ *'The conversion costs for the banks could reach around HRK 8bn or EUR 1.1bn, imposing losses for the banking sector equalling to around three years of expected profits'*, ECB Opinion CON/2015/32, p. 5.

⁸¹ ECB, Opinion CON/2015/32, paragraph 3.2.2.

⁸² Buchen, et al. (2016), p. 12-13.

⁸³ ECB, Opinion CON/2015/32, paragraph 3.2.1.

⁸⁴ Central Bank of Hungary (2013), p. 1.

creditworthiness was not assessed, and they were not warned of the exchange rate risk⁸⁵. In 2014, foreign currency loans to households accounted for 54 % of all loans granted in Hungary⁸⁶. The depreciation of the local currency against the foreign currency to which the loans were linked created serious difficulties in meeting payments that *'has become not only a major problem from a financial consumer protection standpoint, but also a key economic policy, social and public policy issue'*⁸⁷.

In order to tackle this *'policy priority'*⁸⁸ and respond to the ESRB recommendations, various measures were adopted that have come to the rescue of borrowers through **a law converting their loans into domestic currency**. This law was adopted without the compulsory consultation of the ECB⁸⁹. Even in cases of particular urgency, the national authorities are not relieved of their duty to consult⁹⁰. Its retroactivity *'does not seem to be in line with the general aim and principle of Article 23(5) of Directive 2014/17/EU'*⁹¹. This may have an adverse effect on stability. The ECB recommends *'an appropriate burden sharing among all stakeholders and avoid moral hazard in the future'*⁹².

The incorporation of the MCD into national law has been conditioned by the problem of foreign currency loans and the measures adopted to manage it. Standardisation of agreements and certain price limits have been stipulated⁹³. The large number of measures adopted to manage the crisis and respond to the ESRB recommendations⁹⁴, as well as the incorporation of the MCD into domestic law have brought into question the effectiveness of the new legal framework by hindering the identification of the applicable law by consumers and even by judges⁹⁵.

4.4. Poland

In Poland, a sharp rise in the marketing of foreign currency loans, mainly in CHF, took place between 2006 and 2008⁹⁶. As in other CEEC, it is a combination of an attractive offer due to the difference in interest rates and borrowers' aspirations to buy a home. According to the Office of Competition and Consumer Protection's (OCCP) findings, *'banks at the stage of concluding agreements did not inform about currency risk in a comprehensive manner'*⁹⁷.

However, unlike the situation in other countries in the region, in Poland this kind of loan *'does not generate significant risk to the stability of the financial system.'*⁹⁸ There has been an **impact on consumers, in particular the most vulnerable**. According to the OCCP, it

⁸⁵ See Fejős (2017), p. 139.

⁸⁶ See ECB, Opinion CON/2014/59.

⁸⁷ Central bank of Hungary (2013), p. 1.

⁸⁸ Fejős (2017), p. 140.

⁸⁹ See ECB, Opinions CON/2014/59 and CON/2014/87.

⁹⁰ See ECB, Opinions CON/2014/59 and CON/2014/87. The ECB has assessed the situation in the Hungarian financial market in relation to foreign currency loans in several opinions: Opinions CON/2010/62, CON/2011/87, CON/2012/27 and CON/2014/85.

⁹¹ See ECB, Opinion CON/2014/59, p. 4.

⁹² See ECB, Opinion CON/2014/59, p. 5.

⁹³ See Fejős (2017), pp. 142 and 143.

⁹⁴ Central Bank of Hungary (2013), which lists 34 measures in its Attachment, both legally binding acts/decrees and non-binding regulatory tools adopted in Hungary in response to the ESRB recommendations.

⁹⁵ Simon (2016), p. 6.

⁹⁶ Habdas (2017), p. 5. See also FSC (2017).

⁹⁷ Response to Research Questionnaire, Office of Competition and Consumer Protection (OCCP), Warszawa, 10 January 2018 (DOI K-0720-1 118/MF), according to which banks have been notorious for introducing wide currency spreads and employing certain unfair practices.

⁹⁸ FSC (2017); with regard to floor clauses cases, the OCCP is currently conducting the preliminary proceeding which was initiated due to a consumer complaint.

is estimated that the total number of loans in CHF amounts to 1.83 million, which constitutes 7 % of total loans⁹⁹.

Poland opted to extend consumer credit protection to mortgage lending, including specific rules about contractual information and formalisation of mortgage lending¹⁰⁰.

In 2006, the Polish Financial Supervision Authority approved a code of good practices for mortgage lending with a more rigorous assessment of borrowers' creditworthiness¹⁰¹. The marketing of loans in foreign currency was then made conditional upon previously offering the loan in local currency and a statement by the borrower that he was warned of the additional risk. In 2008, new requirements to inform borrowers were included and LTV ratios were introduced in 2011¹⁰². The marketing of foreign currency loans was restricted in 2013¹⁰³.

The Polish Banking Association considers that risk assessment of foreign currencies must remain a part of every bank's lending process and that banks should not be forced to create a new process increasing the burden of regulatory compliance¹⁰⁴.

In 2017, Poland's Financial Stability Committee (FSC) passed a resolution with recommendations for the authorities aimed at restructuring foreign currency loans based on voluntary agreements between banks and their customers¹⁰⁵. The purpose is to strengthen confidence, increase legal certainty and maintain stability.

Several petitions have been made to the European Parliament¹⁰⁶. There seems to be a need to enhance financial consumer protection¹⁰⁷. The incorporation of the MCD into national law was performed through the Law of 23 March 2017 on mortgage credit and supervision over credit intermediaries and the European Commission is currently assessing this law to verify whether it is fully in line with the Directive's requirements.

4.5. Romania

In 2015, there were 75 412 borrowers with CHF loans in Romania. These represented almost 10% of the total volume of loans to households¹⁰⁸. According to the Romanian Association of Banks, the number of borrowers in CHF fell to 35 000 in September 2017¹⁰⁹. Foreign currency indebtedness leads to difficulties for a number of borrowers to repay their debt¹¹⁰, although the National Bank of Romania (NBR) says it is not of systemic importance for financial stability¹¹¹.

⁹⁹ Response to Research Questionnaire, OCCP, Warszawa, 10 January 2018 (DOI K-0720-1 118/MF).

¹⁰⁰ Nierodka (2016).

¹⁰¹ See FSC (2017).

¹⁰² Habdas (2017), p. 9 to 11.

¹⁰³ See FSC (2017).

¹⁰⁴ Polish Bank Association Response to EBA Consultation on the Draft Guidelines on capital measures for foreign currency lending to unhedged borrowers under the Supervisory Review and Evaluation Process (SREP) (EBA/CP/2013/20), Warsaw, 20 August 2013.

¹⁰⁵ FSC (2017).

¹⁰⁶ European Parliament, Notice to Members, Petition No 0175/2017 by M.R. (Polish) on Directive 2014/17/EU of the European Parliament and of the Council on credit agreements for consumers relating to residential immovable property, 31 October 2017; and European Parliament, Notice to Members, Petition 0114/2014 by K. P. (Polish), on unfair banking practices, 29 May 2015.

¹⁰⁷ Habdas (2017), pp. 23-28, citing a large amount of case law.

¹⁰⁸ NBR (2015), p. 7.

¹⁰⁹ Response to Research Questionnaire, Romanian Association of Banks.

¹¹⁰ NBR (2015), p. 22.

¹¹¹ NBR (2015), p. 7.

The National Authority for Consumers Protection (NACP) received approximately 4 000 consumer complaints on problems with the interest rate clauses both consumer and mortgage credits against credit institutions in 2008, 3 000 in 2009 and 14 389 in 2010¹¹². These complaints reflect credit institutions' practice to attract customers without providing complete information about the level and the variation of the interest rate¹¹³.

In August 2008, banks were required to amend their lending rules to enhance assessment of borrowers' creditworthiness considering the risk of foreign currency loans¹¹⁴. The NBR issued public warnings regarding the risks related to foreign currency loans¹¹⁵. In October 2011, the NBR issued regulations on household loans to incorporate the ESRB principles such as capping the LTV ratio¹¹⁶.

The NBR advocates customised solutions, negotiated between credit institutions and borrowers¹¹⁷. In this regard, banks have implemented measures to address the difficult situation of some of their clients. By the end of August 2016, 78% of customer requests were approved¹¹⁸.

Legislative measures have also been adopted. In November 2015, a law was passed **allowing repossession in lieu of payment (*datio in solutum*) with retroactive effect**¹¹⁹. On its own initiative, the ECB issued an opinion, warning the Romanian authorities about the consequences the measure would have on legal certainty and the fact that it infringed Article 28(4) of the MCD¹²⁰. The ECB proposed, as an alternative, encouraging bilateral or group agreements through insolvency proceedings, for example¹²¹.

4.6. Other Member States

Mis-selling of mortgage loans in foreign currency has also taken place in some euro area countries though **not with systemic importance** in relation to financial stability.

In **Greece**, 65 000 households took out mortgage loans in CHF in between 2006 and 2009¹²². The depreciation of the euro against this currency caused difficulties for borrowers¹²³. In 2016, one third of them had renegotiated their loans in order to deal with the difficulties and another third were in payment arrears. The affected people have joined in associations to defend their interests and various court judgments have accepted their claims¹²⁴. A question was posed to the European Commission regarding this problem¹²⁵ and a report by the Hellenic Consumers' Ombudsman¹²⁶ mentions the lack of information about risks when taking out these loans. Although the MCD does not have retroactive effect, its incorporation into national law may have effects on legal disputes concerning loans taken

¹¹² Response to Research Questionnaire, NACP, pp. 1 and 2.

¹¹³ See Response to Research Questionnaire, NACP.

¹¹⁴ NBR (2015), p. 25.

¹¹⁵ NBR (2015), p. 26.

¹¹⁶ NBR (2015), p. 28.

¹¹⁷ NBR (2015), p. 36.

¹¹⁸ Response to Research Questionnaire, Romanian Association of Banks.

¹¹⁹ Calu (2017).

¹²⁰ ECB, Opinion CON/2015/56, pp. 3-4.

¹²¹ ECB, Opinion CON/2015/56 (2015), p. 4.

¹²² Moraitis (2017), p. 8.

¹²³ Moraitis (2017), p. 8.

¹²⁴ See Kaprou (2017), p. 137.

¹²⁵ Question for written answer to the Commission, Notis Marias (ECR), Protection of borrowers who have concluded contracts with Greek banks for mortgages in Swiss francs, E-006878-14, 12 September 2014; with Answer given by Ms Jourova on behalf of the Commission, E-006878/2014, 12 February 2015.

¹²⁶ Report dated 17.09.2015, cited by Moraitis (2017), p. 9.

out prior to its entry into force, as it affects the interpretation of the principle of good faith that governs relations between banks and their customers¹²⁷.

Foreign currency mortgage loans have also been sold in **France**, giving rise to various lawsuits¹²⁸. The prudential banking regulator published a recommendation in 2012¹²⁹ and another in 2014¹³⁰. The Consumer Code was amended to make the sale of these kinds of loans conditional upon a statement by consumers saying that they receive their income or own their property in the relevant currency¹³¹. When the MCD was incorporated into national law, a EUR 300 000 fine was stipulated for breach of the rules governing the marketing of these kinds of loans¹³².

Foreign currency mortgage loans have also been sold in **Spain**. Those affected have grouped together in various associations. In some cases, the people affected have accepted the restructuring offer made by the bank, having been forced to do so by their precarious situation. Others have taken court action¹³³. The court documentation centre (*'Centro de Documentación Judicial'*, commonly known as *'CENDOJ'*) records 175 judgments¹³⁴, including three Supreme Court judgments, which initially applied the MiFID to this product due to considering it a financial instrument¹³⁵. This doctrine was amended¹³⁶ after the CJEU judgment of 3 December 2015¹³⁷ excluded these kinds of bank loans from application of the MiFID. The Bank of Spain report makes frequent references to complaints concerning multicurrency mortgage loans¹³⁸. In 2011, the obligation to *'warn the borrower about the risk of exchange rate fluctuation'* was removed¹³⁹. As a preventive measure, the sixth section of the general principles applicable to the granting of responsible loans from 2012¹⁴⁰ concerns loans with multicurrency or floor rate clauses. According to this section, when granting loans in foreign currency, the information must be sufficient for borrowers to be able to take well-founded, prudent decisions and understand at least the effects on repayments of a sharp depreciation in the euro and an increase in the foreign exchange rate.

There are other interesting examples from other Member States¹⁴¹. For example, there was a recent ruling in **Germany** that decided in favour of the customer, which was not a private individual but rather a public legal entity, a local community¹⁴².

¹²⁷ See Moraitis (2017), p. 25.

¹²⁸ See Henry, (2016).

¹²⁹ ACPR, *Recommandation sur la commercialisation auprès des particuliers de prêts comportant un risque de change* (2012-R-01), 6 April 2012.

¹³⁰ ACPR, *Recommandation sur la commercialisation auprès des particuliers de prêts comportant un risque de change* (2015-R-04), 2 March 2015.

¹³¹ See article L. 312-3-1 Code de la consommation, introduced by Loi n° 2013-672 du 26 juillet 2013 de séparation et de régulation des activités bancaires.

¹³² See Aubry (2017), p. 176.

¹³³ Response to Research Questionnaire, ASUFIN, p. 1, and Plataforma de Afectados por la Hipoteca - PAH Madrid, p. 2.

¹³⁴ Available at <http://www.poderjudicial.es/search/indexAN.jsp> [last visit 21.01.2018].

¹³⁵ Spanish Supreme Court Judgment 323/2015, of 30 May.

¹³⁶ Spanish Supreme Court Judgment 608/2017, of 15 November.

¹³⁷ CJEU Judgment of 3 December 2015, Banif Plus Bank, case C-312/14.

¹³⁸ See Bank of Spain (2012), pp. 336-338 and Bank of Spain (2016), p. 75-76.

¹³⁹ Article 6.5 of the Order of 5 May 1993 on transparency in the financial conditions of mortgage loans, repealed by Order EHA/2899/2011 of 28 October.

¹⁴⁰ In Annex VI of Bank of Spain Circular 5/2012 of 27 June to credit institutions and payment service providers concerning the transparency of banking services and responsibility in granting loans.

¹⁴¹ Regarding the Italian problems and the relevant case law, see Dalmartello, A., 'Appunti sulla distribuzione di mutui indicizzati a una valuta estera' (2017).

4.7. Summary of forex cases

Irresponsible foreign currency lending in some CEEC is a systemic problem from the point of view of both financial stability and consumer protection. In this context, household overindebtedness '*became a major social problem, which resulted in a strong deterioration of the confidence in the financial intermediary system*'¹⁴³. **Loans were marketed without suitable assessment of creditworthiness and without warning of the risks** in a manner comprehensible to the consumer. The lack of EU standards may have contributed to the mis-selling. When the ESRB detected the problem, it recommended the adoption of measures to manage the systemic risk and protect the consumer.

Article 23 of the MCD regulates '*foreign currency loans*', a generic term that comprises various forms including loans denominated in foreign currency and those linked to a foreign currency or that have conversion clauses. The usual procedure is for the consumer to receive and pay the loan in the local currency they conduct their everyday life in. Banking authorities should clarify the interpretation of this term.

This article establishes the right to convert the credit agreement into an alternative currency or provide suitable hedging by putting arrangements in place to limit the exchange rate risk¹⁴⁴. However, it expressly prohibits the retroactive application of these or other measures that may be adopted by Member States¹⁴⁵. Measures that grant a general right to convert the loan into local currency at the exchange rate at the time the loan was taken out are thus contrary to the MCD¹⁴⁶. These measures must be justified and proportionate, taking account of consumers' vulnerability¹⁴⁷. Legal certainty in financial contracting must be guaranteed.

¹⁴² See *The Bundesgerichtshof about Fx-Loans*, available at <http://www.fxloans.org/germany-the-bundesgerichtshof-about-fx-loans/>; with link to Jugdement XI ZR 152/17, decided on 19 December 2017 http://www.fxloans.org/wp-content/uploads/2018/02/S_171219_FXLOANS_DEUTSCHLAND.pdf.

¹⁴³ Cyman (2017), p. 456.

¹⁴⁴ Article 23.1 MCD.

¹⁴⁵ Article 23.5 MCD.

¹⁴⁶ See ECB, Opinion CON/2015/32, paragraph 3.5.3, citing paragraph 3.4 of Opinion CON/2014/59, paragraph 3.3 of Opinion CON/2014/87 and paragraph 3.3.4 of Opinion CON/2015/26, according to which '*due consideration should always be given to fair burden sharing among all stakeholders, thus also avoiding moral hazard in the future*'.

¹⁴⁷ See Domurath (2017), pp. 78-123.

5. THE CASE OF FLOOR RATE CLAUSES

KEY FINDINGS

- The mis-selling of mortgage loans with floor rate clauses is a systemic risk in Spain.
- The Bank of Spain has been slow in imposing monetary fines.

5.1. A systemic problem

The case of mis-selling of mortgage loans with floor rate clauses is an aspect of banking customer protection peculiar to Spain¹⁴⁸. It is a problem of systemic importance¹⁴⁹. Floor rate clauses are downward limitations on the interest on variable rate mortgage loans. These limitations have **prevented consumers from benefiting from falls in interest rates during the financial crisis**. This has created difficulties with meeting mortgage repayments and resulted in evictions. It is a matter of transparency rather than legality. Floor rate clauses are lawful if they are transparent¹⁵⁰. Whether they are suitable for consumers is different matter.

Instead of offering the consumer a fixed-rate mortgage loan, the usual practice was to offer a variable-rate mortgage loan to which a '*hedging*' product was added in order to control the risk of changes in the interest rate. This was either a floor rate clause or a swap¹⁵¹. In 2010, 97 % of mortgage loans were variable-rate indexed to Euribor or, in some cases (13%), the Mortgage Loan Reference Index (IRPH), an index '*whose evolution replicates Euribor with some delay*'¹⁵². That year, one third of mortgage loans granted in Spain included floor rate clauses¹⁵³. In 2009, the percentage of mortgage loans with a floor rose to 38 %, the highest percentage since loans with mortgage floors began in 2003.

The number of complaints made by consumers to the Bank of Spain, as part of the out-of-court redress system, concerning floor rate clauses have fallen as the dispute moves to the courts¹⁵⁴, from 18 387 in 2013 to 15 595 in 2014, 9 354 in 2015 and 3 954 in 2016.

¹⁴⁸ This problem did not occur in the same magnitude in any other Member State. See Missé (2018), and Better Finance (2017), p. 19.

¹⁴⁹ See IMF (2017), paragraph 155, p. 50; Bank of Spain (2017), pp. 46-47, Box 2.2: '*Floor rate clauses in mortgage loans to consumers: legal rulings and their consequences*'. Similarly, the Bank of England includes misconduct costs as a prudential risk. See Bank of England (2015), Part B, Box 3, p. 43.

¹⁵⁰ However, the inclusion of floor rate clauses in mortgage loans without a corresponding cap clause may be contrary to consumer rights. This question has been analysed in some countries in relation to the possibility of introducing clauses limiting the payment of negative interest by the banks. This is the view taken in Croatia, where the HNB has expressly prohibited zero floor rate clauses through which the banks sought not to have to apply negative interest rates, in Response to Research Questionnaire, HNB, 15 February 2018, p. 3.

¹⁵¹ See Bank of Spain, Report, Official Parliamentary Gazette, Senate, Series No 457, 7 May 2010, pp. 12-26.

¹⁵² According to the Bank of Spain Report, by 2009 it had already deviated from Euribor, being 1.96 % higher, and this upward deviation has continued over time. The result is that consumers with mortgage loans indexed in this way face repayment instalments much higher than they would if their loans were indexed to Euribor. The Supreme Court has taken the view that since it is an official index, it is transparent (Supreme Court Judgment 669/2017 of 14 December, with two judges submitting a personal vote). A request for a preliminary ruling has been made to the CJEU, Case C-125/18, though the Order of Barcelona Court of First Instance no. 38 of 16 February 2018, which requested that the accelerated procedure be used as it affected the homes of a million households.

¹⁵³ According to Bank of Spain data: Report to the Senate, April 2010.

¹⁵⁴ Bank of Spain (2016), p. 14: '*The proliferation of court judgments concerning this matter allows us to assume that there is increasing use of the courts to settle disputes*' which '*explains the lower use of the complaints system*'. The Bank of Spain '*does not have powers to assess or interpret contractual clauses or rule on their possible abusiveness*' so '*it is no surprise the claimants and financial institutions seek alternatives to settle their disputes*'. This trend to turn to the courts is reinforced by the fact that Bank of Spain decisions that meet the customers' concerns are not binding on financial institutions. Furthermore, one must take into account that, according to the General Council of the Judiciary (CGPJ): '*98.3% of the more than 9,000 court judgments*

In order to facilitate the reimbursement of amounts unduly paid by consumers to lending institutions by application of certain floor rate clauses, the Spanish government approved a procedure¹⁵⁵ and created a Follow-up Committee¹⁵⁶. According to data published by this Committee, by 30 September 2017, 1 052 789 requests for reimbursement of amounts unduly charged had been received. This is 12.3% of outstanding mortgages in Spain¹⁵⁷. The banks accepted 453 622 requests and repaid EUR 1 497 763 594 in cash. In all, one in eight mortgage consumers in Spain requested the reimbursement of unduly collected amounts and the banks paid out for fewer than half of the complaints. More than half a million of complainants have not received the expected response¹⁵⁸ and are considering taking legal action to have the money returned, which is **causing a collapse of the court system**¹⁵⁹ and the creation of special courts. According to data from the General Council of the Judiciary (CGPJ), from 1 June to 17 December 2017, 156 862 lawsuits were filed concerning floor rate clauses¹⁶⁰. This collapse may explain why complaints submitted to the Bank of Spain in 2017 reached a historic high of 40 173 complaints, 80.4% of them concerned mortgages, mainly floor rate clauses and mortgage expenses¹⁶¹.

Moreover, the use of IRPH as a mortgage loan index has given rise to various complaints and lawsuits¹⁶². The CGPJ database refers to 64 judgments¹⁶³, of which one is a Supreme Court judgment¹⁶⁴. The Bank of Spain complaints report mentions the growing importance of consumer complaints related to application of the IRPH¹⁶⁵.

handed down in 2017 by courts specialising in abusive clauses found for the customer' (CGPJ Press Release dated 16 March 2018. Available at: <http://www.poderjudicial.es/cgpj/es/Poder-Judicial/En-Portada/EI-98-3-por-ciento-de-las-mas-de-9-000-sentencias-dictadas-en-2017-por-los-juzgados-especializados-en-clausulas-abusivas-fueron-favorables-al-cliente>).

¹⁵⁵ Royal Decree-Law 1/2017 of 20 January on urgent measures to protect consumers in relation to floor rate clauses, validated by a Congress of Deputies Resolution of 31 January 2017.

¹⁵⁶ Royal Decree 536/2017 of 26 May, creating and regulating the Monitoring, Supervision and Assessment Committee envisaged in Royal Decree-Law 1/2017 of 20 January on urgent measures to protect consumers in relation to floor rate clauses, validated by a Congress of Deputies Resolution of 31 January 2017. A newly created committee made up of representatives of the Bank of Spain, the Government, the Board of Consumers and Users, the General Council of Spanish Lawyers, the General Council of the Judiciary, and the Spanish Mortgage Association.

¹⁵⁷ First six-monthly report by the Monitoring, Supervision and Assessment Committee envisaged in Royal Decree-Law 1/2017 of 20 January on urgent measures to protect consumers in relation to floor rate clauses, in November 2017, p. 9-10; available at http://www.mineco.gob.es/stfls/mineco/economia/ficheros/Primer_Informe_Comision_clausulas_suelo.pdf.

¹⁵⁸ 204 996 complaints were rejected (the total number of complaints was not stated in the report). A further 343 043 applications were not considered; 42 815 due to the financial institution deeming the applicant not to be a consumer, 146 660 due to deeming the agreement not to contain a floor rate clause and 153 568 for unspecified reasons. In short, one in eight mortgage consumers in Spain requested the reimbursement of unduly collected amounts and the banks paid out for fewer than half of the complaints. See First six-monthly report by the Monitoring, Supervision and Assessment Committee envisaged in Royal Decree-Law 1/2017 of 20 January on urgent measures to protect consumers in relation to floor rate clauses, in November 2017, p. 9-10; available at http://www.mineco.gob.es/stfls/mineco/economia/ficheros/Primer_Informe_Comision_clausulas_suelo.pdf.

¹⁵⁹ See Íñigo De Barrón, 'Las cláusulas suelo y los gastos de la hipoteca disparan las quejas al supervisor un 177%', *El País*, 6 April 2018. Available at https://elpais.com/economia/2018/04/06/actualidad/1523031451_271953.html.

¹⁶⁰ See CGPJ press release of 28 December 2017; available at <http://www.poderjudicial.es/cgpj/es/Poder-Judicial/En-Portada/EI-CGPJ-aprueba-el-diseno-de-un-nuevo-plan-sobre-clausulas-suelo-para-2018>.

¹⁶¹ See Íñigo De Barrón, 'Las cláusulas suelo y los gastos de la hipoteca disparan las quejas al supervisor un 177%', *El País*, 6 April 2018. Available at https://elpais.com/economia/2018/04/06/actualidad/1523031451_271953.html.

¹⁶² European Parliament. Committee on Petitions. Notice to members. Petition 1249/2013 by Manuel García Barba (Spanish) on the use of a mortgage loan reference index to set mortgage interest rates, 21.12.2016.

¹⁶³ Available at <http://www.poderjudicial.es/search/indexAN.jsp> [last visit 21.01.2018].

¹⁶⁴ Spanish Supreme Court Judgment, 669/2017, of 14 December.

¹⁶⁵ Bank of Spain (2015), pp. 29 and 73.

In turn, regarding swaps, which are mostly associated with mortgage loans, there are 451 judgments¹⁶⁶, of which 73 are Supreme Court judgments. One third were filed by private individuals and two thirds by SMEs with the courts finding in favour of the consumer claimant in 86% of cases¹⁶⁷.

The Bank of Spain Report to the Senate of 27 April 2010¹⁶⁸ was limited to analysing floor rate clauses as hedging against interest rate changes. It refrained from issuing an opinion on reciprocity or disproportionality as it considered this was a question that should be resolved by the courts. However, in its report, the Bank of Spain made legal assessments that were contrary to the most recent case law.

- It considered floor rate clauses to constitute the *'price of the money being lent'*, the main purpose of the contract and, as such, not able to be categorised as abusive. This view is opposed to CJEU case law¹⁶⁹ and Spanish Supreme Court case law¹⁷⁰.
- Floor rate clauses *'are valid provided they arise from an agreement and are expressly stated in the contract'*. This view opposes the one set out in the CJEU Judgment of 21 December 2016¹⁷¹ and Spanish Supreme Court case law¹⁷².
- Regarding swaps offered as alternative hedging to floor rate clauses, the Bank of Spain took the view that the regulations did not impose *'a specific duty to inform of the risk undertaken by the consumer when entering into one of these hedging instruments'* on credit institutions. This is contrary to the CJEU Judgment of 30 May 2013¹⁷³ and the European Commission's interpretation¹⁷⁴.

Apart from these legal considerations, the Bank of Spain provides two reasons in favour of using variable-rate mortgage loans with floor rate clauses.

- Due to cognitive biases that affect customers, since *'private individuals do not appear to sufficiently appreciate the financial benefits of certainty regarding repayments'*.
- Because the floor guarantees *'minimum income for the institution granting the loan, whatever the current interest rate situation in the markets'*.

It concludes that floor rate clauses are *'positive'* and that *'doing away with them could result in either a decrease in the volume of available mortgage credit or an increase in the cost of the loan and a reduction in the term of transactions'*.

Contrary to this assessment, the Spanish Ombudsman's report in January 2012¹⁷⁵ issued an alert about a **lack of consumer protection and a risk of overindebtedness caused by irresponsible mortgage lending**.

The number of complaints received, and the seriousness of the abuse set out in them led the European Parliament to pass a resolution on *'Mortgage legislation and risky financial*

¹⁶⁶ Available at <http://www.poderjudicial.es/search/indexAN.jsp> [last visit 21.01.2018].

¹⁶⁷ Jausas (2016), p. 6.

¹⁶⁸ See Bank of Spain, Report, Official Parliamentary Gazette, Senate, Series No 457, 7 May 2010, pp. 12-26.

¹⁶⁹ CJEU Judgment of 21 December 2016, *Gutiérrez Naranjo* (joined cases C-154/15, C-307/15 and C-308/15) and CJEU Judgment of 26 January 2017, *Banco Primus* (C-421/14). See Dalmartello, A., 'Epilogo della questione della clausola floor in Spagna? Chiarimenti della Corte di Giustizia sugli effetti della non vincolatività delle clausole abusive' (2017).

¹⁷⁰ Judgment 241/2013 of 9 May.

¹⁷¹ CJEU Judgment of 21 December 2016, *Gutiérrez Naranjo* (joined cases C-154/15, C-307/15 and C-308/15).

¹⁷² Supreme Court Judgment 138/2015 of 24 March.

¹⁷³ CJEU Judgment of 30 May 2013 (Case C604/11) on a request for a preliminary ruling by Madrid Court of First Instance no. 12 (ES).

¹⁷⁴ ID 842. Definitions (Internal reference 269.) financial instrument – IRS related to mortgage loan Back Relevant provisions Article 4(1) (17) of Directive 2004/39/EC Annex I, Section C of Directive 2004/39/EC.

¹⁷⁵ Defensor del Pueblo (2012), presented on 12 April 2013 at the Congress of Deputies.

*instruments in the EU: the case of Spain*¹⁷⁶. This resolution sets out the complaints about abuses in mortgage loans identified by the courts that are giving rise to thousands of evictions. It also lists similar complaints concerning the placement of preference shares and other risky products for consumers¹⁷⁷. These cases reflect problems in the conduct of banking business in Spain that *'have brought to light thousands of tragic personal cases in which citizens experienced the partial or entire loss of their life savings'*¹⁷⁸. There are also cases that reflect the questionable measures adopted by the Spanish government to manage the **eviction problem**. Against this background, the resolution recommends monitoring the implementation and correct application of EU directives and judgments, and that the Spanish government should adopt new measures¹⁷⁹. Financial education is considered to play an important supplementary role in preventing overindebtedness and improving financial decision-making.

However, the problem is not limited to floor rate or multicurrency clauses. Many other clauses included in mortgage loans are being revoked by the courts, such as those that used the IRPH as an alternative index to Euribor¹⁸⁰, mortgage fees¹⁸¹, early termination¹⁸², extrajudicial sale¹⁸³, allocation of payments¹⁸⁴ and default interest¹⁸⁵, among others¹⁸⁶. This creates a **serious problem with legal certainty as well as systemic risk**¹⁸⁷. The various judgments handed down on floor clauses and, in particular, the CJEU's judgment annulling the limitation on retroactivity¹⁸⁸, has compelled financial institutions to record

¹⁷⁶ European Parliament resolution of 8 October 2015 on mortgage legislation and risky financial instruments in Spain (based on petitions received) [2015/2740(RSP)].

¹⁷⁷ Zunzunegui (2014), pp. 185 and 186; Missé (2016), pp. 319-341.

¹⁷⁸ European Parliament resolution of 8 October 2015 on mortgage legislation and risky financial instruments in Spain (based on petitions received) [2015/2740(RSP)], paragraph A.

¹⁷⁹ The European Parliament *'Calls on the Spanish Government to make use of the tools at its disposal in order to find a comprehensive solution for drastically reducing the intolerable numbers of evictions'* and warns the Commission of the doubts *'concerning the legality of the measures adopted by the Spanish Government to resolve the infringements denounced by the Court of Justice on 14 March 2013 and prevent abusive practices in the mortgage sector'*.

¹⁸⁰ In this regard, the European Commission is carrying out special monitoring of changes in the IRPH and application in Spain of Regulation 2016/1011 on indices used as benchmarks in financial instruments. In the Motion of resolution on mortgage legislation and risky financial instruments in Spain (based on petitions received) (2015/2740(RSP)) of 2.10.2015 *'Warns that, as pointed out in Petition 1249/2013, the use of the Benchmark Mortgage Loan Index for loans goes against Directive 93/13/EEC'*; although this paragraph of the motion was not included in the text adopted by Parliament. See European Parliament resolution of 8 October 2015 on mortgage legislation and risky financial instruments in Spain (based on petitions received) [2015/2740(RSP)].

¹⁸¹ See Judgments of the Plenary Session of the Supreme Court 147/2018 and 148/2018, of 15 March, clarifying the previous Judgement 705/2015, of 23 December, who declared abusive to charge indiscriminately to the consumer all the expenses and taxes derived from the operation.

¹⁸² See Spanish Supreme Court Judgment 705/2015, of 23 December, and Carrasco (2018), who criticises the bill that introduces a confusing regulation on early termination.

¹⁸³ See Spanish Provincial Court of Palma de Mallorca Judgment, 12 May 2014, Castaños, *'Problemas de legalidad del procedimiento notarial de ejecución hipotecaria'* (2017) and *'¿Es abusiva la cláusula que prevé la posibilidad de la venta extrajudicial del bien hipotecado?: Comentario a la Sentencia del Tribunal Supremo de 25 de abril de 2017'* (2017).

¹⁸⁴ See Spanish Provincial Court of Gipuzkoa Judgment, of 31 March 2017.

¹⁸⁵ See Spanish Supreme Court Judgment 705/2015, of 23 December; 364/2016, of 3 June; and 79/2016, 18 February. See Nieto Carol (2017).

¹⁸⁶ The *'Notarios y Registradores'* [Notaries Public and Registrars] portal lists as many as 92 clauses that have already been successfully challenged in court. See *List of possible abusive clauses judged by the courts by Registrar Carlos Ballugera*, in *Notarios y registradores*; available at: <https://www.notariosyregistradores.com/web/secciones/consumo-y-derecho/clausulas-de-hipoteca/lista-y-clausulas-en-3-bloques/lista-numerada-de-las-clausulas-con-link/>.

¹⁸⁷ According to Kepler Cheuvreux Analysts, the risk of lawsuits for mortgage mis-selling is estimated in EUR 32 700 million. See Portillo, J., *'La banca se juega 33.000 millones en los juzgados'*, *Cinco Días*, 5 May 2018. Available at: https://cincodias.elpais.com/cincodias/2018/05/04/midinero/1525446516_756401.html.

¹⁸⁸ CJEU Judgment of 21 December 2016, *Gutiérrez Naranjo* (joined cases C-154/15, C-307/15 and C-308/15).

additional provisions of around EUR 1.9 billion in their 2016 income statements. This amount '*demonstrates the impact of legal risk on banks' profitability and, consequently, on the need for this risk to be properly monitored, managed and provisioned*'¹⁸⁹.

The Spanish Banking Association (AEB) takes the view that there has not been an issue of mis-selling in Spain in relation to either floor rate clauses or foreign currency loans¹⁹⁰. The AEB considers Spanish banks to have complied with the industry regulations and states that, having acted in good faith, they are surprised by the change in the Supreme Court's doctrine that requires additional information not covered in the rules '*that the banking institutions therefore had no way of knowing about*'¹⁹¹. However, the banks '*have taken the necessary measure to adapt to the jurisprudence established in the field of transparency*'¹⁹².

5.2. Management of the problem

5.2.1. The Bank of Spain's role

Although this is a case of mis-selling of systemic importance with thousands of judgments to support it, no penalties have been imposed. According to the IMF, the **Bank of Spain has been slow in imposing monetary fines** in the case of credit institutions¹⁹³. In the past three years, it has imposed only one fine, EUR 150 000 in respect of a consumer protection infringement in a credit cooperative. No monetary fines have been imposed in respect of infringements of prudential rules.

The Bank of Spain's efforts are focused on protecting the stability of banking institutions in view of the effects that bad practices may have on their balance sheets. This has led the IMF to recommend that the banks '*must be monitored to ensure they have provisioned adequately in respect of recent litigation cases, e.g., mortgage "floor clause" liabilities and fees incurred by mortgage customers at the commencement of the loan*'¹⁹⁴. However, at the same time, it recommends that the '*approach to the prudential impact of conduct risk and consumer protection issues should be further developed in a pro-active direction*'¹⁹⁵.

5.2.2. Legislative initiatives

The Spanish parliament and government's main measure to ensure legal certainty and financial contracting is to require, as a condition for all new mortgage credits, the bank's customer to provide a **signed handwritten note** in which he acknowledges that he has been informed and understands the information he has received about risks¹⁹⁶. This is an attempt to prevent the consumer from seeking the transaction to be revoked in the future

¹⁸⁹ Bank of Spain (2017), p. 47, Box 2.2: 'Floor rate clauses in mortgage loans to consumers: legal rulings and their consequences'.

¹⁹⁰ Response to Research Questionnaire, AEB, 15 February 2018, p. 3.

¹⁹¹ Response to Research Questionnaire, AEB, 15 February 2018. pp. 2 and 3.

¹⁹² Response to Research Questionnaire, AEB, 15 February 2018. p. 4.

¹⁹³ See IMF (2017), paragraph 155, p. 50.

¹⁹⁴ IMF (2017), paragraph 169, p. 53

¹⁹⁵ IMF (2017), paragraph 177, p. 54.

¹⁹⁶ There is a precedent in Poland, Recommendation S, Part 19, of March 2006 in which the Polish Supervision Authority for Banking recommended that the bank may make a customer an offer of credit, loan or other product in a foreign currency or indexed to foreign currency only after the customer of the bank has made a written statement attesting that he chose the offer in foreign currency or indexed to foreign currency in full awareness of the risks. See Ratcliffe (2014); Habdas (2017), p. 9.

due to lack of '*material transparency*' in the event of a poor result from the financial product or service¹⁹⁷.

In 2012, this measure was used in the stock market as a condition for providing investment services¹⁹⁸. This inclusion has been criticised by ESMA¹⁹⁹. In 2013, the measure was extended to the mortgage market as a condition for natural persons to take out mortgage loans with floor rate clauses, swaps or foreign currency clauses²⁰⁰.

Against this background, the handwritten statement, reinforced by the involvement of a notary public as the consumer's adviser, has become the main measure of the bill incorporating the MCD into national law in order to provide legal certainty for mortgage loans. It is a measure that turned notaries public into financial advisers of consumers, which is a task they are neither authorised nor qualified to perform²⁰¹. It is a measure that deviates from the concept of the MCD.

- It goes against the principle of effectiveness that should apply to obligations to inform²⁰². The requirement for the customer to sign a statement that he was informed does not constitute compliance with the obligation to verify that the customer understands the financial risks.
- It reverses the burden of proof and leaves the customer unprotected. In principle, the burden of proof to inform the customer lies with the financial institution. However, the requirement for a handwritten statement means that the customer must prove that there was a lack of information (*probatio diabolica*).
- It questions the application of the principle of proportionality in performing duties to inform. This requirement increases regulatory compliance costs without this being justified by enhanced consumer protection.

¹⁹⁷ A case law concept that adds a second filter of the comprehensibility of the clause by the consumer to the requirement for textual clarity.

¹⁹⁸ Article 79 bis.7 of the Stock Market Act (LMV), as drafted by Act 9/2012, included in the current article 214.5 of the Revised Text of the Stock Market Act (TRLMV). According to this rule, when the transaction concerns a complex instrument, the customer must state that he has been warned that the product is not appropriate for him or that it has not been possible to assess him. In order to contract these kinds of products, the customer must write, in his own hand: '*This product is complex and not considered appropriate for me*'. The bank may require him to add the following handwritten note: '*I have not been advised about this transaction*'. All this is prior to signing the document in which these statements are included above the signature (CNMV Circular 3/2013).

¹⁹⁹ After reviewing an onsite visit to the CNMV, the assessment group (AG) concluded that '*the existence of the handwritten note could be used by firms to protect themselves in any supervisory case or litigation that sought to establish whether advice had been provided to the client*'. ESMA (2016), pp. 34-35. They did not find the CNMV's explanation that this legal disclaimer has eliminated the legal disclaimers previously used to be reasonable.

²⁰⁰ Article 6 of Act 1/2013 of 14 May on measures to strengthen protection of mortgage debtors, restructure debt and social rental. The terms of this handwritten note were determined by the Bank of Spain in Annex IX of Circular 5/2012 of 27 June. According to this annex, the customer must write and sign, in his own handwriting: '*I am aware that my mortgage loan is granted in several currencies and, in addition, I have been warned by the lender and by the authorising Notary Public, each within their own scope, of the possible risks of the contract and, in particular, that my loan is not denominated in euros and, therefore, the amount in euros that I will need to pay for each instalment will vary in accordance with the other currency's exchange rate*'. According to Segismundo Álvarez Royo-Villanova, a notary public from Madrid: '*this guarantees nothing and is also based on an erroneous premise, that the person signing an agreement does not have the capacity to understand what he is reading*'. See Viejo González and Álvarez Royo-Villanova (2013). According to María Pilar de Prada Solaesa, a notary public from Madrid, the requirement for this handwritten statement '*implies deep ignorance of the nature and formalities of public deeds and the set of actions performed by a notary public in authorising them, which makes it utterly unnecessary*'. See Prada Solaesa (2014), p. 12.

²⁰¹ See Articles 9 and 22, and Annex III MCD.

²⁰² Articles 13, 14 and 16 MCD.

It is a *'useless overprotection'* that may give rise to a large number of court cases²⁰³. It also goes against the trend of digitalisation in the provision of financial services. Alternative means must be found to achieve legal certainty in contracting of mortgage loans.

5.2.3. Special system for complaints and judicial reorganisation

The massive number abuses in credit contracts have caused a reaction among customers, giving rise to thousands of court claims that have referred to consumer law due to the lack of a specific contractual framework for mortgage loans. Judges have resorted to refer prejudicial questions²⁰⁴ that clarify the compatibility of domestic law with EU law²⁰⁵. Regarding this, the European Parliament has recognised that *'Thanks to infringement proceedings brought by the European Commission and to the case law of the CJEU, Spain has made important progress in the application of consumer law'*²⁰⁶.

The most relevant case and of the greatest economic importance is the use of floor rate clauses in mortgage loans. The Supreme Court sought to limit the impact of the revocation of floor rate clauses on the financial system's stability by limiting its retroactivity²⁰⁷, but this was rectified by the CJEU²⁰⁸ since the revocation of this kind of clauses, as with other abusive clauses, implies the non-existence of the clause with effect from the time of contracting.

Two measures have been put in place to manage the obligation to return the excess charged through floor rate clauses: the creation of a **specific court claim system** and a **judicial reorganisation** in order to handle tens of thousands of claims.

Royal Decree-Law 1/2017 of 20 January 2017 on urgent measures to protect consumers in the matter of floor rate clauses creates a **specific complaints system** for floor rate clauses controlled by the banks, who can decide whether or not to admit the complaint at their own discretion, in parallel to the general system controlled by the Bank of Spain²⁰⁹, to which consumers continue to have access. The new complaints system does not comply with EU standards, but the general system does²¹⁰.

It is an *ad hoc* regulation to deal with a situation of systemic importance²¹¹. It establishes a complaints procedure prior to the courts that limits consumers' procedural rights in order to encourage them to follow this procedure. The rule includes measures that honour neither the principle of equivalence, as they are less favourable than those that applied in similar

²⁰³ Just as measures of this kind did in France. See Lasserre Capdeville (2013), p. 1460.

²⁰⁴ *'If a national court is in doubt about the interpretation or validity of an EU law, it can ask the Court for clarification. The same mechanism can be used to determine whether a national law or practice is compatible with EU law'* (see https://europa.eu/european-union/about-eu/institutions-bodies/court-justice_en).

²⁰⁵ List of Requests for a Preliminary Ruling. There were 65 concerning consumer protection between 2010 and 2017 and none between 1999 and 2009. Available at: <http://www.poderjudicial.es/cgpj/es/Temas/Estadistica-Judicial/Estadistica-por-temas/Aspectos-internacionales/Cuestiones-prejudiciales-ante-el-Tribunal-de-Justicia-de-las-C-E-/>.

²⁰⁶ European Parliament. Committee on Petitions. Notice to members. Petition no 0644/2016 by Francisco Verdun Pérez (Spanish) on behalf of Verdun Abogados, on unfair terms and the failure of Spanish courts to take action in defence of consumers, 28.2.2017.

²⁰⁷ Supreme Court Judgment 138/2015 of 24 March.

²⁰⁸ CJEU Judgment of 21 December 2016, *Gutiérrez Naranjo* (joined cases C-154/15, C-307/15 and C-308/15).

²⁰⁹ Order ECC/2502/2012 of 16 November, regulating the procedure for presenting complaints to the complaint services of the Bank of Spain, the Spanish Securities and Exchange Commission and the Directorate General for Insurance and Pension Funds.

²¹⁰ The Bank of Spain's Market Conduct and Complaints Department has been assessed in accordance with Article 20 of Directive 2013/11/EU of 21 May 2013 on alternative dispute resolution for consumer disputes.

²¹¹ Bank of Spain (2017), p. 47, Box 2.2: *'Floor rate clauses in mortgage loans to consumers: legal rulings and their consequences'*.

situations, nor the principle of effectiveness, as they do not make it easier for consumers to exercise their rights.

The system does not have the characteristics for being considered an alternative dispute resolution (ADR) system and is not subject to Directive 2013/11/EU on alternative dispute resolution for consumer disputes.

- It lacks independence as it operates under the control of the credit institution the complaint is made against. There is no impartial third-party to resolve or propose a solution to the dispute.
- It is not transparent as it does not allow the customer to access the file.
- It is not effective as it allows the institution to leave the complaint unanswered.
- It is not faster than the general system, since in the general system the institution must reply to the complaint within two months whereas in the floor rate clauses system it has at least three months to reply to the consumer's complaint.

For these reasons, the floor rate clauses complaint system also cannot be included in the FIN-NET²¹² alternative dispute resolution network within the field of financial services to which the general system belongs.

The special procedure for floor rate clauses complaints has a Monitoring, Control and Assessment Committee²¹³. The General Council of Lawyers' representative on this committee described the procedure as '*unnecessary*' and as '*privileging the banks*'²¹⁴.

On 25 May 2017, the CGPJ approved the **establishment of specific courts to hear cases concerning floor rate clauses**²¹⁵. This measure was adopted after the period that was given to the institutions by Royal Decree-Law 1/2017 to reach agreements with their customers in view of the foreseeable avalanche of court claims from dissatisfied customers had expired. In fact, the 156 862 court claims filed by 17 December 2017 led to a new plan for floor rate clauses being designed for 2018. This was approved by the CGPJ on 28 December 2017²¹⁶. According to the Council, we are facing '*a workload that cannot be borne by the rest of the courts*'²¹⁷.

²¹² Information on FIN-NET available at: https://ec.europa.eu/info/business-economy-euro/banking-and-finance/consumer-finance-and-payments/consumer-financial-services/financial-dispute-resolution-network-fin-net_en.

²¹³ Royal Decree 536/2017 of 26 May, creating and regulating the Monitoring, Supervision and Assessment Committee envisaged in Royal Decree-Law 1/2017 of 20 January on urgent measures to protect consumers in relation to floor rate clauses, validated by a Congress of Deputies Resolution of 31 January 2017. This is the second monitoring committee that the Government has created to manage mass mis-selling. The previous one was set up to monitor the specific arbitration for those affected by the mis-selling of preference shares. See the *Report by the Monitoring Committee for Hybrid Capital Instruments and Subordinated Debt*, of 17 May 2013, included in his personal opinion; available at: <http://www.rdmf.es/wp-content/uploads/2013/05/informe-comision-seguimiento-preferentes-cnmv-bde.pdf>. There was a highly critical personal vote by the representative of the Consumers and Users Council.

²¹⁴ Interview with Vicente Pascual, a member of the Floor Rate Clauses Monitoring Committee, representing the General Council of Lawyers, 17 January 2018, available at: <http://www.abogacia.es/2018/01/17/v-pascual-miembro-comision-control-clausulas-suelo-la-justicia-no-puede-soportar-650-000-nuevos-pleitos/>.

²¹⁵ See CGPJ press release of 25 May 2017, available at: <http://www.poderjudicial.es/cgpj/es/Poder-Judicial/En-Portada/EI-CGPJ-aprueba-la-especializacion-de-54-juzgados-para-conocer-de-los-litigios-por-las-clausulas-suelo>.

²¹⁶ See CGPJ press release of 28 December 2017, available at: <http://www.poderjudicial.es/cgpj/es/Poder-Judicial/En-Portada/EI-CGPJ-aprueba-el-diseno-de-un-nuevo-plan-sobre-clausulas-suelo-para-2018>.

²¹⁷ See CGPJ press release of 28 December 2017, available at: <http://www.poderjudicial.es/cgpj/es/Poder-Judicial/En-Portada/EI-CGPJ-aprueba-el-diseno-de-un-nuevo-plan-sobre-clausulas-suelo-para-2018>. The plenary session of the General Council of Catalan Lawyers disagreed with the new plan (available at: http://www.iustel.com/diario_del_derecho/noticia.asp?ref_iustel=1173683&utm_source=DD&utm_medium=e-mail&utm_campaign=31/1/2018).

Associations of affected customers regard the measures adopted as not being sufficiently effective. The affected customers have had to go to court to seek redress. *'The judges have been crucial in defending the rights of consumers in our country'*, says the *'Asociación de Usuarios Financieros'* (ASUFIN)²¹⁸.

5.2.4. Bill to incorporate the MCD into national law

Spain has missed the deadline for transposing the MCD into Spanish law. It is the last Member State to take steps to do so²¹⁹. The Spanish parliament requested immediate incorporation of the directive in 2014, in view of the serious mortgage problems²²⁰.

The bill regulating real estate credit agreements²²¹ is intended to transpose the MCD into Spanish domestic law and is intended to radically change the contracting of mortgage loans by amending eleven legislative acts²²². It merely transcribes what is laid down in the MCD regarding certain aspects such as creditworthiness assessment and regulation of foreign currency loans. It goes beyond the rules of the MCD in other respects. These are the main new aspects:

- It expands protection to all the **natural persons**, whether consumers or not, including self-employed workers.
- It **standardises the information** and provides the customer with a cooling off period to analyse it²²³.
- Customers are required to make a signed **handwritten statement** that they have received, understood and accepted the precontractual information that the bank must provide the customer with, as a condition for receiving the loan.
- It makes **notaries public** financial advisers of customers taking out a mortgage. They must advise them by answering their questions²²⁴. The tests that the customer was given regarding his understanding of the practical application of the financial clauses in the contract must be stated in the deed.
- It regulates the **advisory service** for mortgage loans, distinguishing independent advice from dependent advice.
- It leaves the conditions and effects of **creditworthiness assessment** of the potential borrower to be developed in regulations, excluding contractual remedies that require authorisation by law. This measure may be contrary to Article 38 (2) MCD, which requires penalties to be *'effective, proportionate and dissuasive'*.

²¹⁸ Response to Research Questionnaire, ASUFIN, 29 January 2018, p. 3, adding that: *'The Ombudsman (Defensor del Pueblo) has also helped, denouncing the bad banking practices and, above all, the bad functioning of the regulators'*.

²¹⁹ See <http://eur-lex.europa.eu/legal-content/EN/NIM/?uri=celex:32014L0017> [viewed on 24.01.2017].

²²⁰ According to Additional Provision Twenty of the Credit Institutions Creditworthiness, Supervision and Regulation Act, in order to improve the regulations protecting banking customers and, in particular, mortgage debtors, the government must propose a bill in Parliament, within one year, to incorporate the MCD into Spanish law.

²²¹ Published in the Official Parliamentary Gazette, Congress of Deputies, Series A, No. 12-1 17 November 2017.

²²² A measure presented in Congress by Minister De Guindos in these words: *'Monitoring at the time the mortgage loan is signed is strengthened in order to verify that the customer has actually received the pre-contractual information duly in advance. As we did in 2013 with floor rate clauses, the consumer must write a handwritten note in which he states that he accepts and understands the contents of this standard form and the clauses in the contract.'* (Parliamentary Record, Congress of Deputies, Committees, no. 103, 31/01/2017).

²²³ *'It is not fully in accordance with the EU regulations'*, Hernández Sáinz (2017), p. 36.

²²⁴ See Hernández Sáinz (2017), 35. According to this, *'the new proposed regulation makes the notary public the watchful guardian of compliance with pre-contractual information obligations imposed on the banks'*.

- It allows banks to require customers to **take out an insurance** to guarantee performance or a property damages insurance as a condition for taking out a mortgage loan.
- It fixes **default interest** at three times the legal interest rate²²⁵, which could mean it is a penalty and contrary to Article 28(2) MCD.

The bill authorises the government to approve a standard mortgage loan form that institutions may choose to use²²⁶. In this way, the government is seeking to offer the banks a **safe harbour when entering into** mortgage loan contracts aiming to avoid the danger of including abusive clauses²²⁷. It is a proposal that has already been tried out in other legal systems with divergent results²²⁸. In a financial market with constant innovation, the official form would soon become outdated and its use would compromise financial innovation²²⁹. In addition, there is a risk that the official model would not filter out all abusive clauses. This could open the door to the government being liable for the contractual model complying with the official standard.

In short, the bill has been drafted with the main aim of achieving legal certainty in mortgage contracting with the side effect of providing a safe harbour for the banks in view of the constant complaints from consumers. To this end, it turns to notaries public to draft deeds that comply with material transparency. Consumers are forced to visit the notary public before contracting in order to state, in their own handwriting, that they have been informed and have understood the risks, even the more complex clauses²³⁰. The consequence is the reversal of the burden of proof. It is the customers who will have to prove to the judge that they were not informed (*probatio diabolica*). While the Spanish government's intention to seek legal certainty in mortgage contracts is laudable, the bill diverts from the MCD's objective to protect consumers.

²²⁵ The legal interest rate in Spain is 3% (Additional provision forty-four, 2017, General State Budget Act 3/2017 of 27 June), which would give a default rate of 9%.

²²⁶ Final provision eleven of the bill.

²²⁷ According to Minister De Guindos: *'The contract will be straightforward, easy to understand, transparent and not create any kind of doubt or alternative interpretations. In some manner we are going to offer a kind of model agreement that, if the parties so deem appropriate, will not generate any kind of uncertainty from the viewpoint of its contents and will become the agreement generally used.'* (Parliamentary Record, Congress of Deputies, Plenary Session and Permanent Committee, no. 27, 01/02/2017). The proposal by Alejandro Fernández de Araoz Gómez-Acebo, in his seminal, award-winning article 'Rethinking investor protection: bases for a new real estate contracting system' follows on from this. The author considers the disputes between banks and their customers to be creating great legal uncertainty and that it is necessary to provide operators with a safe harbour.

²²⁸ In Italy, which has a long-standing tradition of standardisation of banking contracts, their compatibility with regulations protecting free competition is disputed. See Longobucco (2016). Moreover, in the United States, doctrine questions the benefits of standardisation. See Patterson (2010).

²²⁹ Article 13.2.d) of the Real Estate Credit Contracts Bill, available at http://www.congreso.es/public_oficiales/L12/CONG/BOCG/A/BOCG-12-A-12-1.PDF#page=1 See Response to Research Questionnaire, Spanish Minister of Economy, Industry and Competitiveness, 20 March 2018, which states: *'this possibility is a powerful mechanism reacting against possible mis-selling that could arise in the future insofar as it will allow it to be identified in regulations and incorporated into the model of good practices that may be appropriate at any time.'*

²³⁰ Response to Research Questionnaire, Spanish Minister of Economy, Industry and Competitiveness, 20 March 2018, which highlights that the bill *'strengthens legal certainty and the foreseeability of the economic effects arising from the agreement'* and, with this aim in mind, the borrower *'will be forced to appear before a notary public during that period, prior to signing, in order to receive specific, free advice about the conditions of his agreement, which will ensure he has full knowledge of all of its legal and economic implications.'* This criterion has already been stated in Spanish case law. See the Judgment of the Plenary Session of the Supreme Court 205/2018 of 11 April, which stated: *"Although handwritten transcription of the clause is not necessarily equivalent to real comprehensibility by the consumer who writes it, it undoubtedly contributes to realising it exists and highlighting its contents. In fact, it has been the usual form employed since judgment 241/2013 of 9 May in order to provide proof of compliance with the duties of transparency. It is echoed in article 13.2.d) of Credit Agreements relating to Residential Immovable Property Bill"*.

6. CONCLUSIONS

Following analysis of the legal framework and the main cases of mis-selling in mortgage lending, the following conclusions can be drawn:

- The **objectives of banking stability and consumer protection** are complementary. Without protection, consumers lose trust in the system and the loss of trust harms financial stability. The banking authorities now acknowledge mis-selling as a prudential risk²³¹. According to the IMF, *'Conduct and customer protection issues can impact banks' reputation and profitability (via customers' redress and/or fines) and, ultimately, their solvency too'*²³². Mis-selling of mortgage loans not only affects consumers' property, it also damages their health.
- The banks must prioritise the **customer's interests** when selling mortgage loans. It is not sufficient merely to comply with the industry's transparency rules. In turn, customers need to understand that financial products and services are increasingly complex and should improve their financial education and take their cognitive biases into account.
- Mis-selling of mortgage loans gives rise to **different perceptions**. There are banks that think they have been complying with the industry's transparency requirements towards their customers and that claims for risks that subsequently arose as a consequence of the financial crisis go against their good faith. They think it is a retrospective bias, because their duties of conduct must be based on the rules and circumstances in force at the time the agreements are entered into. In turn, consumers think that there has been mis-selling by the banks since they were not warned about the various scenarios, in particular about the risks that came along with the financial crisis.
- Consumers are affected by **cognitive biases** that are worsened when institutions offer complex financial products such as mortgage loans with floor rate or foreign currency clauses. There are cases of opportunism in which the banks have taken advantage of these cognitive biases when marketing this kind of loans by highlighting the initial advantages without warning of the risks that may arise, such as not benefiting from the lowering of interest rates in loans with floor rate clauses or the cost of an unfavourable exchange rate in foreign currency loans leading to an unbearable rise in mortgage repayments.
- Offering **risk-hedging products** with mortgage loans through derivatives is not always in the consumer's interests. There are cases in which swaps have been contracted to hedge the interest rate risk that have caused heavy losses for consumers.
- The problems that arose through complex mortgage loans which included risks that consumers were not aware of gave rise to retroactive remedies that were not in line with the legal certainty or prohibitions that were not in line with the freedom of contract. However, there are also cases of legal disclaimers intended to prevent future claims by customers. The **response to the problems has to be balanced**, maintaining legal certainty and freedom of contract, while strengthening consumer protection.
- The **MCD is a beneficial framework** for consumer protection but it lacks the desired effectiveness. One of its main achievements is the creditworthiness assessment

²³¹ Similarly, the Bank of England includes misconduct costs as a prudential risk, in Bank of England (2015), Part B, Box 3, p. 43.

²³² IMF (2017), paragraph 177, p. 54.

provision. When the assessment is negative, the loan should not be granted. However, there are no remedies provided in the event of breach of this obligation²³³.

- The approval of **technical guidelines** by financial authorities through non-legislative rules leads to harmonising the criteria followed by the courts in interpreting financial agreements. This reinforces the effectiveness of the protection of financial consumers and, indirectly, the stability of the institutions and the system as a whole.
- **CJEU case law** emerging from requests for preliminary rulings by national courts is having a determining effect on redressing the harm caused by mis-selling of mortgage loans, in particular through the inclusion of floor rate and foreign currency clauses. Prior to the entry into force of the MCD, consumer protection focused on the application of EU consumer law and national contractual law. Self-regulation by the financial industry has proven to be insufficient to guarantee the stability of the mortgage market and consumer protection.
- The retroactive application of measures to protect overindebted consumers as a consequence of mis-selling of mortgage loans must be justified on the defence of the most vulnerable with eligibility requirements. The ECB has stated this in various reports. Introducing **measures with retroactive effect** *'risks undermining legal certainty and is not in line with the principle of legitimate expectations'*²³⁴. The measures adopted by national authorities to incentivise agreements between banks and affected customers to redress the damage and restructure agreements have not achieved this aim.

²³³ Jordan (2017), p. 32.

²³⁴ For all, see ECB, *Opinion of the European Bank of 18 December 2015 on discharge of mortgage-backed debts through transfer of title over immovable property* (2015), p. 3.

7. RECOMMENDATIONS

7.1. Action plan

The recent transposition of the MCD into national law makes prudence advisable when assessing its principles. They still need to be specified by regulatory and non-regulatory documents of the European financial authorities²³⁵. At the moment, **the problem is not a lack of rules but rather of setting standards and enforcement**.

The European Commission shall undertake a **review of the MCD** by 21 March 2019²³⁶, including a report on overindebtedness²³⁷. It must also assess financial education in order to pinpoint the most suitable practices²³⁸. The issues listed for review are no doubt relevant, such as the objective and subjective scope of the directive, its coordination with the Consumer Credit Directive and the review of obligations to inform. However, there are aspects that have not been mentioned that should be included in that review. These are as follows:

- Stipulating **civil sanctions** for breach of the obligation to assess creditworthiness²³⁹. This provision should come with clear criteria for exempted transactions in order to prevent the financial exclusion of people who cannot pass the creditworthiness assessment based on Article 3.3.c) of the MCD.
- The appropriateness of **setting EU standards for LTV and LTI ratios** is a relevant issue for both consumer protection and banking stability. There are studies that show that when these ratios are high, mortgage default also rises²⁴⁰. The most serious problem that has arisen in some Member States is depreciation of the property and overindebtedness of the consumer who has defaulted on his mortgage, who then not only loses his home but also continues to owe money to the bank²⁴¹. Regulation of the LTV ratio may prevent this problem.
- Analysing **out-of-court dispute resolution mechanisms** and the appropriateness of their decisions being binding on financial institutions.
- Analysing **customers' cognitive biases** and establishing measures to ensure institutions cannot take advantage of such biases.
- Analysing the **impact of FinTech** on the supply of credit for home buying. For example, the appropriateness of allowing crowdfunding for mortgage financing could be analysed²⁴².

Until the review of the MCD in March 2019, efforts must be focused on **setting standards and guidelines** for conduct of business for institutions in accordance with the business obligations to act *'honestly, fairly, transparently and professionally, taking account of the rights and interests of the consumers'*²⁴³. Application of the principle **to act in the consumers' interests** requires **a change to financial institutions' culture**. It is not sufficient to formally comply with the requirements to inform. It is necessary to verify that

²³⁵ ECB and ESAs.

²³⁶ See Article 44 MCD.

²³⁷ See Article 45 MCD.

²³⁸ Article 6(2) MCD.

²³⁹ As has been laid down in § 505 d German Civil Code (BGB). See Rank and Schmidt-Kessel (2017).

²⁴⁰ Jordan (2017), note 55, p. 13.

²⁴¹ Fontes da Costa (2017), p. 24.

²⁴² See, in Spain, article 74.2 of Act 5/2015 of 27 April to encourage business financing, prohibiting crowdfunding for projects based on loans that include a mortgage guarantee on the borrower's main home.

²⁴³ Article 7.1 MCD.

the information fulfils its protective function. The regulatory framework should be focused towards a cultural change²⁴⁴.

In applying the principle to act in the consumers' interests to the mortgage market and provide advice appropriate to their needs²⁴⁵, the EBA could take the criteria set by ESMA pursuant to MiFID II as a reference²⁴⁶.

Mortgage credit is an essential financial product for home purchases. Consumer protection must apply **throughout the product's lifetime**, from design to contracting through marketing. The customer's interests must take priority. No mortgage loan agreement should be designed in a way that is not intended to meet consumers' needs. A distinction could be made between simple and complex mortgage loans, the latter category including all loans with complex clauses such as floor rate or foreign currency clauses. The MCD differentiates between loans in terms of the extent of obligations to inform and consumers' rights in relation to foreign currency loans and those that include variable interest rates²⁴⁷. Complex contracts should only be able to be entered into by consumers who have been appropriately advised.

Financial authorities' guidelines and other techniques of supervisory convergence are effective measures to enhance the protection of financial consumers²⁴⁸ affected by mis-selling of mortgage loans. They have been successfully used in areas that are not clearly regulated²⁴⁹. Institutions respect them as if they were orders from the supervisor. The following could be used to determine them:

- Guidelines specifying the **knowledge and competence of employees** who inform and advise on mortgage loans, based on that set forth in Article 9 of the MCD.²⁵⁰
- Guidelines interpreting '*fair and objective compensation*' and its difference to a penalty concerning **early repayment** regulated by Article 25.3 of the MCD.
- Guidelines specifying **the moment when bad practices must be published** once they have been identified by the supervisor, pursuant to Article 38.2 of the MCD²⁵¹. Publication should tend to take place prior to the moment the supervisor begins its investigation, due to having clear circumstantial evidence of '*breaches of the conduct requirements*'.

²⁴⁴ See Goodhart (2017), p. 239: '*If a bank CEO knew that his own family's fortunes would remain at risk throughout his subsequent lifetime for any failure of an employee's behaviour during his period in office, it would do more to improve banking "culture" than any set of sermons and required oaths of good behaviour. The root of the problem is the bad behaviour of bankers, not of banks, who are incapable of behaviour, for good or ill.*'.

²⁴⁵ See article 22 MCD.

²⁴⁶ See Enriques and Gargantini (2017), p. 488-491; Busch and van Dam (2017), pp. 4 and 5; and Conac (2017).

²⁴⁷ Articles 23 and 24 MCD.

²⁴⁸ ESAs have significantly contributed to strengthening of coordination and cooperation among national supervisions and played a key role in ensuring consumers' protection is enhanced, but representatives of consumers and users complain that '*they are outnumbered by the representatives of financial institutions*' (Proposal for a regulation - COM(2017)536/948972, p. TEN and 257).

²⁴⁹ See, for instance, ECB, *Guide to assessments of fintech credit institution licence applications*, March 2018.

²⁵⁰ See, as a reference, ESMA, *Guidelines for the assessment of knowledge and competence*, 3 January 2017, ESMA71-1154262120-153 EN (rev).

²⁵¹ The ESMA stated this regarding its visit to the CNMV: '*The AG also considers that the publication of the names of the firms where the CNMV had identified breaches of the suitability requirements (and in which non-pecuniary sanctions had been imposed) would be a useful preventative measure to address wrongdoing in the market.*'. See ESMA (2016), p. 35.

7.2. Improving financial literacy

The MCD highlights financial education as an important aspect in consumer protection²⁵². However, **financial education has limited effects**. Financial consumers have cognitive biases that reduce its effectiveness. It can only play a supplementary role to codes of conduct.

Enhanced training programmes should be provided for judges concerning financial matters to improve their knowledge in financial matters, in particular with view to complex financial clauses in mortgage loans, such as variable interest with a floor rate or foreign currency clauses. Progress should also be made towards improved application of CJEU case law by national courts. To this end, judicial exchange programs between different EU Member States should be enhanced.

7.3. Twin Peaks approach

The financial authorities have taken on consumer protection responsibilities. They have set up consultation committees in which include representatives of users of financial services. The EBA seeks to foster consumer protection in all EU Member States by identifying and addressing consumer detriment in the financial services sector. Supervisory convergence plans include protection of financial consumers²⁵³.

However, it is questionable whether a single financial authority can take on the objectives of protecting consumers and institutions' stability. Some authors are in favour of the twin peaks²⁵⁴ model in which **tasks are divided between a prudential authority** that looks out for stability **and a conduct authority** aiming at consumer protection. This focus is included in the MCD. Recital 80 allows Member States to designate authorities empowered to ensure enforcement, distinguishing between consumer protection and prudential powers.

7.4. From moral hazard to moral suasion

The MCD does not give retroactive effect to its consumer protection measures. Its effects are preventive, making mortgage loans transparent and appropriate from the time the directive enters into force. It neither contributes to nor solves the harm caused to consumers by mis-selling of mortgage loans granted without clearly warning of the risks or assessing the consumer's creditworthiness prior to its entry into force. Its entry into force should be accompanied with palliative measures to redress the damage caused by mortgage mis-selling.

The costs arising from mis-selling must be borne by the institutions that caused it. General retroactive application of the MCD must be excluded. It is contrary to legal certainty and may have undesired effects. In view of new market circumstances, affected customers may seek retroactive application every time there is a legal change.

The option of creating a taxpayer-financed fund to deal with this kind of conduct would create a moral risk by encouraging aggressive marketing, transferring the risks onto customers who were not informed of them, since if these risks materialised, the losses would have to be covered by the public. Creating an industry-financed fund to cover the risk of this kind of eventualities will also not solve the problem of moral hazard. Institutions that complied with the rules would be subsidising those that did not.

²⁵² Article 6 MCD.

²⁵³ EBA, *Guidelines on creditworthiness assessment* (2015), p. 5; EBA, *Opinion of the European Banking Authority on good practices for mortgage creditworthiness assessments and arrears and foreclosure, including expected mortgage payment difficulties* (2015), p. 3.

²⁵⁴ See Schoenmaker and Véron (2017), p. 4, and Moloney (2014), p. 853. See also Financial Services Users Group (2016), p. 39; and Better Finance (2017), p. 25.

There should be **social policy measures aimed at covering the losses of the most vulnerable consumers**. These measures must be effective and not merely symbolic. They must be simple to apply, making it easy for households affected by mis-selling to avail themselves of them. For instance, through moratoria or partial discharges to give them a second chance.

Other consumers should be provided with **accessible and effective out-of-court dispute resolution mechanisms**. Court proceedings are time-consuming, expensive and create uncertainty for consumers. A large proportion of affected consumers never take legal action due to ignorance, caution or lack of resources to do so.

The out-of-court channel is a more effective way of handling claims that affect thousands of consumers and the most convenient from the standpoint of institutions' stability. Keeping the dispute as a matter for the courts over time tarnishes the banks' reputation, since trust is the basis of the banking business. Continual publication of court judgements in the media harms the banks' image. Handling claims out-of-court makes it possible to reduce the period of exposure to bad news, calculate the total cost and turn the page by paying the corresponding compensation.

When the financial authorities detect, through the system of penalties, decisions in out-of-court procedures or court judgments that there is a case of mass mis-selling they must ensure that the out-of-court system in place is fulfilling its function or take the initiative to set up a system to speed up compensation²⁵⁵.

²⁵⁵ A good example of this is the United Kingdom, where the system for dealing with payment protection insurance (PPI) mis-selling stands out for its simplicity and effectiveness. See <https://www.fca.org.uk/ppi/>.

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Questionnaires

The researcher has requested information, through a questionnaire, from finance ministries, central banks, banking associations, ombudsmen and consumer associations from the countries the research concerns. Personal interviews with some experts in the field were also conducted.

The researcher has received answers from the Croatian National Bank (HNB), the Ombudswoman of the Republic of Croatia, the Hungarian Ombudsman, the Office of Competition and Consumer Protection of Poland, the Romanian Ombudsman, the Romanian Minister of Economy, the Romanian Banking Association, the Bank of Spain, the Spanish Ombudsman, the Spanish Minister of Economy, Industry and Competitiveness, the Spanish Banking Association (AEB), Asociación de Usuarios Financieros (ASUFIN) and Plataforma de Afectados por la Hipoteca - PAH Madrid.

This paper forms part of a series of five studies on mis-selling of financial products in the EU. The mis-selling of mortgage loans that include floor clauses, foreign currencies (forex) clauses and related products is the subject of this research. We analyse the context, the handling of the problem in the most affected Member States (Croatia, Hungary, Poland, Romania and Spain) and its compatibility with EU law. We conclude with recommendations. This document was provided by Policy Department A at the request of the ECON Committee.

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