FINANCIAL MARKETS LAW COMMITTEE

ISSUE 55 – ASSET BACKED BONDS

Report on Conflict of Laws and Mortgage Funding – The Rome I Instrument

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ISSUE 55 – ASSET BACKED BONDS WORKING GROUP

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CONFLICT OF LAWS AND MORTGAGE FUNDING

- THE ROME I INSTRUMENT -

The role of the Financial Markets Law Committee ("FMLC") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

The Department of Constitutional Affairs has asked for the FMLC's views, from the perspective of legal uncertainty and its impact on mortgage funding in the wholesale financial markets, on the proposals set out in the Commission Green Paper on Mortgage Credit in the EU which relate to conflicts rules for mortgages under a forthcoming Rome I Instrument.[1] This paper sets out the views of the FMLC on this subject.

The paper focuses on uncertainty in mortgages, rather than directly on mortgage funding instruments. Mortgage funding instruments are usually on- or off-balance sheet securitisations of pools of mortgages – very often residential mortgages. A securitisation will typically be structured to allow for the issuance of capital market instruments (bonds or other securities), the proceeds of which are applied in paying the purchase price for the sale of the mortgages (or funding the trustee to do so). The securitisation will have a number of features requiring the originating bank to take on the risk that the underlying mortgages are ineligible for the securitisation or will not be repaid. The capital market instruments will, of course, be agency rated. If the originating bank cannot satisfy the rating agency that it has dealt adequately with the underlying risk in relation to the mortgages, the securities would receive a less favourable rating. However, the originator is very unlikely to allow this to happen. Deals are more likely to be structured so that the originating bank absorbs or relocates the risk and incurs the necessary expense in so doing. The risks associated with the underlying mortgages thus translate directly into costs for the originating bank in a securitisation.

In the case of future securitisations, increased risks may act as a disincentive to issue mortgage funding instruments; in the case of existing securitisations they may give rise to significant costs in compensating bondholders or unwinding transactions. The risk in question is usually the risk that the mortgagor will not, or will not have to, repay the mortgage. Mandatory national consumer protection laws often provide that the mortgagor does not have to repay (all of) the mortgage on the terms agreed.

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1 The proposals can be found at paragraphs 31-33 of the Green Paper.

Such laws are likely, therefore, to have a direct effect on securitisations. When these risks are certain and predictable, the originating bank can make appropriate provision for them. However, legal uncertainty as to the extent or nature of consumer protection laws is destabilising and makes financial planning difficult. This paper focuses on uncertainty in relation to mortgages because the impact of this uncertainty is likely to be suffered in the wholesale, as well as the retail, context.

The FMLC is aware of arguments made by industry representatives that stringent but relatively certain consumer protection measures (into which category the first Commission option discussed below may fall) are often contrary to the interests of consumers because they will increase the costs of mortgage funding and, ultimately, of mortgages. The Committee wishes to express no view on this question. The following paragraphs deal only with the aspects of the Commission's proposals which may be regarded as giving rise to increased legal uncertainty.

Comments – the Commission's Proposals

At paragraph 31 of the paper the Commission proposes that questions of applicable law in relation to mortgages should be addressed as part of the current revision process intended to transform the Convention into a Regulation. At paragraph 32, it suggests that there are three possible ways of dealing with the issue:-

- Provide for a specific regime for the law applicable to consumer mortgage credit contracts in the future Regulation. This could consist of aligning the law applicable to the mortgage credit contract with the law applicable to the collateral contract.

- Continue to subject mortgage credit contracts to the general principles which, in the Rome Convention as it stands, would mean essentially that parties can freely decide on the law applicable to their contract, subject to the application - under some conditions - of the mandatory rules of the consumer's country of residence.

- Exclude the application to a consumer mortgage credit contract of the consumer's mandatory protection rules, provided that some conditions are met, for example that there is a high level of consumer protection in place at EU level.

The first of these options creates a new choice of law regime for consumer contracts, the second applies the usual rules of the Rome Convention, and the third applies most of the usual rules of the Rome Convention but disapplies Article 5.

Rome Convention – Article 5

Most mortgage contracts are likely to be entered into with persons acting as consumers within the meaning of Article 5(1), as contracts "for the supply of …. services to a person ('the consumer`) for a purpose which can be regarded as being outside his trade or profession, or a contract for the provision of credit for that object."

Article 5 goes on to provide in paragraphs (2) and (4) that:-

> **(2)** Notwithstanding the provisions of Article 3, a choice of law made by the parties shall not have the result of depriving the consumer of the protection afforded to him by the mandatory rules of the law of the country in which he has his habitual residence:
>
> - if in that country the conclusion of the contract was preceded by a specific invitation addressed to him or by advertising, and he had taken in that country all the steps necessary on his part for the conclusion of the contract, or
>
> - if the other party or his agent received the consumer's order in that country, or
>
> - if the contract is for the sale of goods and the consumer travelled from that country to another country and there gave his order, provided that the consumer's journey was arranged by the seller for the purpose of inducing the consumer to buy.
>
> **(3)** […]
>
> (**4)** This Article shall not apply to:
>
> - a contract of carriage;

- a contract for the supply of services where the services are to be supplied to the consumer exclusively in a country other than that in which he has his habitual residence.

The effect of these provisions is that where a person deals with a consumer in one country under the laws of another, some provisions of the law of the country where the consumer is habitually resident may apply to the contract even though they are specifically excluded by the agreement. The effect of this Article is usually that legal certainty as regards the contract is materially diminished: firstly it is not always clear at the time a contract is concluded whether Article 5 will apply (although this is less likely to be a problem in the case of mortgages, purchase of which is relatively formalised); secondly, there is, in most European jurisdictions, some doubt as to the exact meaning of "protection afforded by the mandatory rules of the law of the country in which he has his habitual residence" (i.e. it is unclear which rules are mandatory and which are not). Moreover, since the Article 5 "choice of law" rule does not displace the usual choice of law rules, it has the effect that a single transaction is likely to be governed by as many as three different legal systems: the consumer's "home" law; the applicable law of the mortgage contract; and the *lex situs* of the property (see below). Whilst this may not necessarily entail greater legal uncertainty, it is highly likely to lead to increased confusion and a lack of transparency (since it is unlikely that all three applicable laws will appear on the face of the transaction).

Cross-border Mortgages

These issues have rarely been considered in the context of mortgage transactions, since in general there is no significant cross-border supply of mortgages. However, the aim of the Commission Green Paper is to examine ways in which such a market could be developed. It is therefore necessary to consider how Article 5 would apply to such transactions.

Under the conflict of laws, a clear distinction must be made between contractual rights arising between the lender ("L") and the borrower ("B") (relating to payment of interest and repayment of principal) and the property rights of L and B in the relevant property ("P"). It is established law that the latter must be determined by reference to the law of the situs of P. The former are determined according to the applicable law of the contract.

Some mandatory national consumer protection laws relate to the property relationship rather than the contractual right. For example, in the UK a mortgagor of property is entitled to the benefit of the

doctrine prohibiting clogs on the equity of redemption. It is not clear whether Article 5, which forms part of a Convention on *contractual* obligations, gives consumers the benefit of mandatory consumer protection laws relating the proprietary aspects of a transaction. Thus, the effect of Article 5 could be that the doctrine on "clogs" is a mandatory UK rule affording protection to UK mortgagors in cross-border mortgages, regardless of the situs of the property or the governing law of the contract. Equally, the doctrine might not qualify as such because it is not, strictly speaking, a rule of contract. The same could be true of the provisions of the Law of Property Act 1925 relating to mortgagees, since the terms of the act do not seem to be limited to English property. The position is entirely unclear.

A further issue arises out of the tension between certain cross-border transaction patterns. Consider the case of a UK bank lending to an English customer to buy a villa in Spain. The customer will have the benefit of UK regulation of whatever provisions of English law fall within the definition of mandatory consumer protection provisions, and the benefit of whatever doctrines of Spanish property law apply to mortgages of Spanish property. Assume that the customer takes the loan, moves to Spain, and then wants to move house within Spain. He enters into an identical contract with the same lender in respect of a new property, but the terms of the contract will be distinctly different in that the customer will have lost the benefit of UK mandatory consumer protections, but will now be entitled to the benefit of whatever the relevant mandatory consumer protection provisions of Spanish law may be (as a result of Article 5's reference to the law of the consumer's habitual residence). Interestingly, if instead of moving within Spain the customer had decided to move back to England, he would get a different set of rights again, since he would then be entitled to the benefit of Spanish mandatory consumer protection and of English property law protection, as well as UK regulation of mortgage lending. In the other scenarios the position may be more complex still.

It therefore seems to the FMLC that the consequences of the application of Article 5 in its current unamended form to cross-border mortgages would give rise to considerable legal uncertainty (and constitute a significant impediment to the development of the Commission's own policy of encouraging the development of cross-border mortgage business in the EU) for three reasons:-

1. the legal uncertainty created by the provisions of the article would be a deterrent to banks and other lenders, who generally will not lend without a reasonably robust legal framework within which to do so;

2. the practical difficulties of assessing the "country of habitual residence" in respect of someone who either owns or is buying property in a different country make the test inappropriate on these facts; and

3. the interaction between the consumer protection provisions of ordinary contract law and the borrower protection provisions of property law mean that almost every cross-border mortgage will give rise to significant dépeçage issues.

A single restrictive choice of law rule for consumer contracts is preferable to the awkward and uncertain combination of two or three applicable laws under the Rome Convention from the perspective of legal certainty. However, this would significantly reduce the parties' freedom of contract. The application of most of the usual Rome Convention rules combined with the disapplication of Article 5 is in line with the Commission's own thinking in other areas - for example, the Commission note in the Green Paper (annexe 1 paragraph 4) that mortgages are to be excluded from the proposed Directive on Consumer Credit and subjected to a different, specialised regime. The same approach could be relatively easily achieved by the addition of mortgage lending to the list of exclusions from Article 5 contained in Article 5(4).

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