

Global trends

Housing finance is enjoying robust growth in many countries across the globe, in both developed and emerging markets. Dr Michael Lea analyses the data

Housing finance is a booming business globally – in developed markets since the 1990s (see figure 1) and more recently in emerging markets (see figure 2). Mortgage debt exceeds 40% of gross domestic product (GDP) in most developed countries, with several countries (Australia, UK and the US) exceeding 70% and one (Netherlands) exceeding 100%. Countries with growing economies have experienced the strongest growth while slow growth economies (Germany and Japan) exhibit negligible recent growth. Although emerging markets' mortgage debt is typically much smaller relative to their economies, as a percentage of GDP it now exceeds 10% in several major emerging markets (China, Mexico and Thailand) and 20% in several others (Chile, Korea, Malaysia and South Africa).

Growth drivers

There are a number of reasons why housing finance is enjoying robust growth in so many countries. These include strong economic growth, financial liberalisation and increased competition. Declining and low inflation and interest rates have been particularly important drivers.

The example of Spain is quite instructive. Spain began liberalising its financial markets in the 1980s (including privatisation of the state housing bank). Interest rates decreased sharply in the 1990s as a result of Spain joining the common European currency, and economic growth surged. As a result, the

size of the mortgage market relative to GDP more than doubled, from 17% in 1990 to 42% in 2004.

It is no coincidence that the strongest growth in emerging markets has been registered in countries with robust economic growth and low interest rates (China, India, Korea and Malaysia).

The shifting attitude of consumers towards owner-occupied housing should not be overlooked. Once considered mainly as a consumption good, housing is increasingly seen as a financial asset that can be borrowed against for housing investment (capturing potential capital gains), non-housing investment (to purchase shares or start new business) and consumption. Equity withdrawal and increased leverage have been prominent in a number of countries (Australia, UK and the US). Governments aid and abet this trend through the tax system, providing deductibility of mortgage interest for owner-occupied housing (in Denmark, Netherlands and the US) and preferential treatment of capital gains (in Australia and the US).

One by-product of the growth in housing finance is rising house prices. The increase in house prices has been

and many emerging markets). These circuits were typically supported by various tax and regulatory incentives for housing finance specialists and restraints on competition.

As part of a broader financial liberalisation trend in the 1980s in developed markets the special circuits were swept away and the markets opened to competition. The main result has been the dominance of universal banks as providers of housing finance.

As shown in figure 3 (on page 8), commercial and savings banks provide more than 70% of housing finance in major developed markets. In Germany and the US, banks are dominant players through their ownership of specialist mortgage banks and companies. Bank domination reflects several factors, including abundant, relatively low-cost deposit funding, and brand and distribution advantages.

Bank players

Banks also dominate in many emerging markets (see figure 4, page 8), although specialist lenders (such as housing finance companies in India, Sofols in Mexico) are important and catalytic lenders. Special circuits are still a major

Two major factors that are shaping the provision of housing finance in the future are regulation and technology

stimulated by economic growth, population trends (immigration and urbanisation) and the relative low cost and abundance of finance.

Circuit switch

Prior to financial liberalisation, housing finance was predominately provided by special circuits (for example, building societies in the UK, savings and loans in the US, housing banks in France, Spain

source of finance in a number of emerging markets (Brazil, Korea and Mexico), typically in the form of wage tax funds earmarked for subsidised housing finance. The performance of these funds over time has been poor, however, and growth in housing finance in these countries is coming from outside the funds.

Mortgage intermediaries (brokers) have become an important distribution

FIGURE 1: MORTGAGE DEBT IN SELECT DEVELOPED COUNTRIES

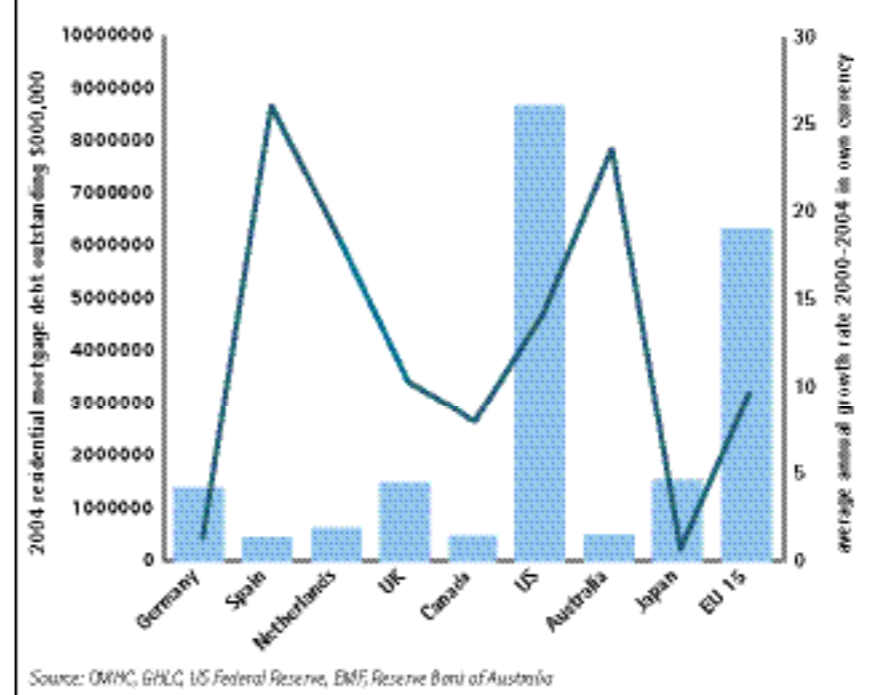
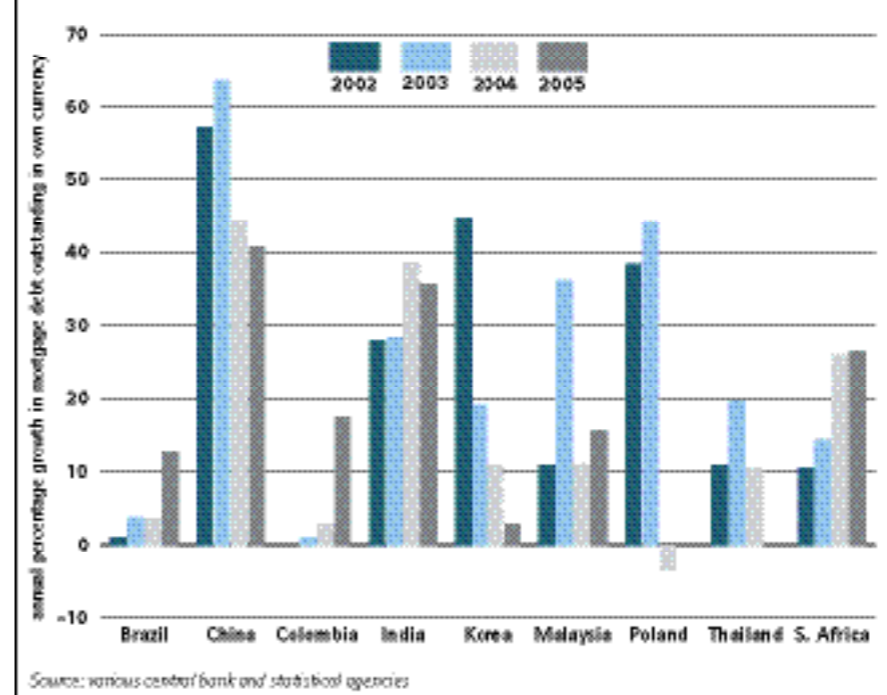


FIGURE 2: MORTGAGE DEBT IN SELECT EMERGING MARKETS



Product development

Mortgage products are becoming more complex and sophisticated. Once limited to plain vanilla, fully amortising variable and fixed rate loans, mortgage products now display a dizzying array of amortisation, interest rate setting formulas and maturities.

In the UK, at any point in time there are literally several thousand product types on offer (admittedly many are subtle variations on a theme). The US, which until recently was dominated by the 30-year fixed rate, level payment mortgage, has experienced a sharp increase in adjustable rate and flexible amortisation products. The adjustable rate mortgage (ARM) option, which allows borrowers to select the amount of principal repayment (ranging from none to full amortisation to partial prepayment) on a monthly basis, has been quite popular, accounting for more than 20% of new lending in 2004 and 2005.

Flexible mortgages allowing payment holidays, offset mortgages linking the mortgage and current account and shared appreciation loans, which trade off current interest for a share in the property capital gain, have become prevalent in Australia and the UK. Home equity lines of credit (linking a credit card to housing equity) and redraw facilities have contributed to increased leverage and equity withdrawal. And longer term loans (up to 50 years) have been introduced in several countries.

Many of these product innovations have been driven by affordability concerns due to high house prices. Others are responding to the changing nature of workforces with more part-time and self-employed workers. In countries with ageing populations, reverse mortgages allow homeowners to liquefy housing wealth without having to sell and move house.

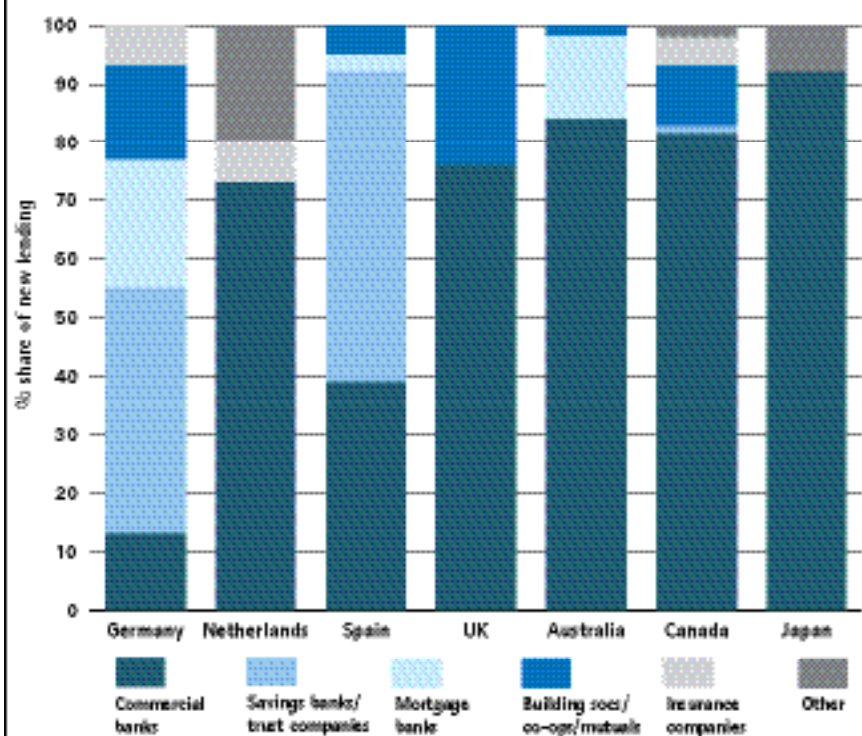
Funding shifts

Housing loans can be funded through retail (deposits) or wholesale (capital market) sources. In addition to deposit and loan-linked savings contracts, the instruments used to access funds include mortgage (covered) bonds, mortgage-backed securities (MBS) and liquidity facility bonds. As shown in figure 5 (page 9), in Europe two-thirds of >>

channel in many countries. Intermediaries account for more than 40% of new lending in several large markets and more than 25% in several more.

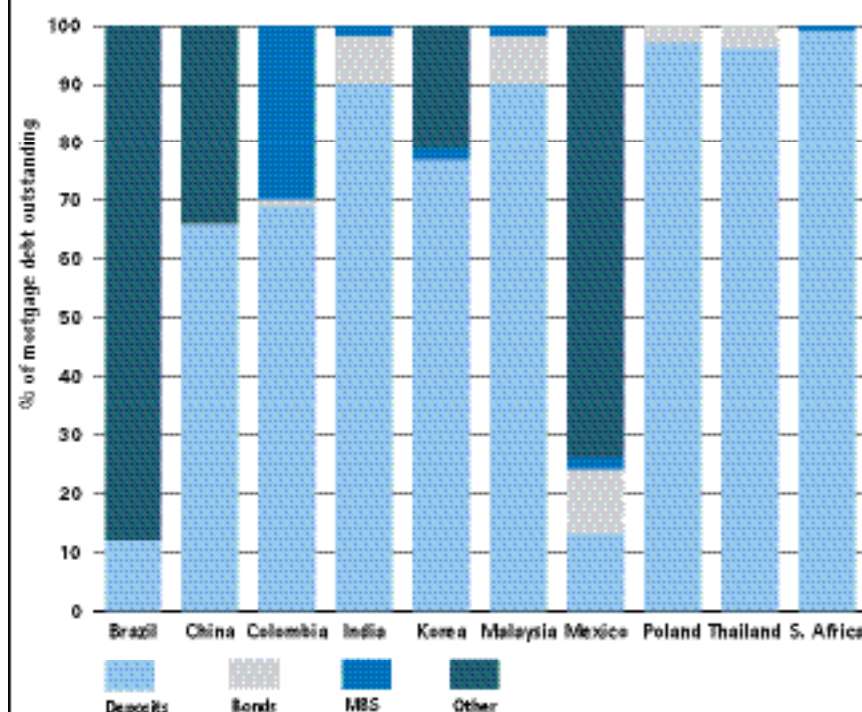
Intermediaries are also becoming important in transition countries, accounting for more than 50% of new lending in the Czech Republic and Poland.

FIGURE 3: MORTGAGE LENDERS IN DEVELOPED MARKETS



Source: BMF (2004), ONHC (2004), GMLC (2004/05), Australian Bureau of Statistics (2005)

FIGURE 4: MORTGAGE FUNDING IN EMERGING MARKETS



Source: author estimates from available data

mortgage funding comes from deposits or dedicated savings contracts. Mortgage bonds provide nearly 20% of funds for housing and MBS, while growing rapidly, account for less than 2%. Purchasers of mortgage bonds and MBS include banks but predominantly go to institutional investors, including pension funds and insurance companies, expanding the supply of funds available for housing.

In contrast, a majority of mortgage funding in the US comes from the capital markets. More than 54% of residential mortgage debt has been securitised and an additional 4% funded through agency (Fannie Mae, Freddie Mac) debt issues (see figure 6, page 9). When funding by the Federal Home Loan Banks (which provide over-collateralised loans to depository institutions funded by debt issues) is added to this distribution, more than two-thirds of funding comes from the secondary markets. A significant portion of MBS and agency bonds are purchased by banks funded by deposits.

Capital markets

There are several reasons for the dominance of the capital markets in funding housing in the US. The bond markets are deep, liquid and desirous of high-quality fixed-income assets. The presence of government-sponsored intermediaries enhances the credit quality and attractiveness of MBS. The traditional dominance of the long-term fixed-rate mortgage that can be fully prepaid without penalty is another factor. This instrument is exceedingly risky for depository institutions to fund (as the savings and loans found out in the late 1970s). The cash-flow risk of these instruments can be managed better in the capital markets.

The only other country in which capital market funding is dominant is Denmark, which traditionally uses the same mortgage instrument.

Although mortgage funding in emerging markets is dominated by retail bank deposits and special circuits, use of the capital markets is increasing in many countries. Mortgage bonds account for a significant proportion of funding in several transition countries (for example, Czech Republic and Hungary) and provide more than 70% of mortgage finance in Chile. MBS are rising in

importance in a number of emerging markets (Korea, Mexico and South Africa). Liquidity facilities fund more than 20% of housing loans in Jordan and Malaysia.

Shaping the future

Two major factors that are shaping the provision of housing finance in the future are regulation and technology. These factors are often intertwined because technology is developed to meet regulatory requirements.

There are two major regulatory trends affecting housing finance. The first is safety and soundness regulation as manifested in Basel II. The adoption of Basel II may have major impacts on the providers of mortgage finance by significantly reducing the amount of capital that banks must hold against mortgages. Specifically, the risk weight for mortgages falls from 50% currently to 35% under the standardised approach and to 20% or less for large banks using the internal ratings-based (IRB) approach (estimating capital needs based on historical loss experience).

The adoption of Basel II may increase the portfolio holdings of mortgages and give large IRB banks a competitive edge in the market. It may result in less securitisation as well.

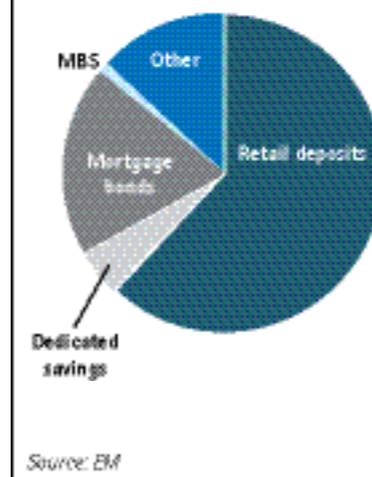
Protection and disclosure

The second major regulatory trend is the strengthening of consumer protection and information disclosure. The proliferation of complex mortgage products and the rise of sub-prime lending have created concern about the ability of consumers to understand properly the risks they are undertaking.

Mortgage advice in the UK is increasingly focused on suitability, requiring originators to ensure that a product is appropriate for the borrower. In Europe, borrowers can escape mortgage obligations if they can prove they were over-indebted. In the US, sub-prime lenders are becoming subject to state predatory lending requirements that are designed to protect unsophisticated borrowers. These regulations increase cost for lenders and intermediaries and potentially threaten the supply of credit to marginal borrowers. Increased automation can reduce some of the compliance risks and costs.

FIGURE 5: EUROPEAN MORTGAGE FUNDING

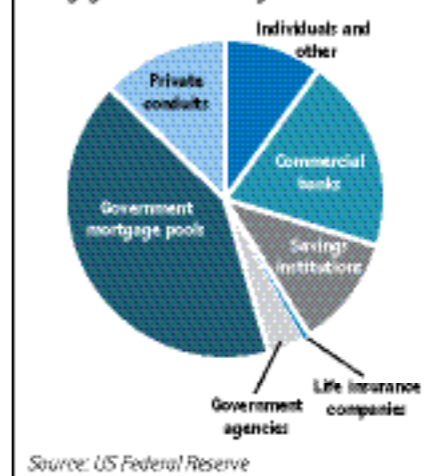
2004: €4700bn (\$6300bn)



Source: EM

FIGURE 6: US MORTGAGE FUNDING

2004 Q4: \$8523bn residential mortgage debt outstanding



Source: US Federal Reserve

reduced time – but at some risk of alienating customers who are accustomed to ‘the human touch’.

Global outlook

The outlook for housing finance across the world is bright. In growing countries with low interest rates, housing finance is likely to grow faster than the underlying economy. Growth will be especially strong in emerging markets that are developing their capital markets and institutional investor base (for example, through private pensions), and strengthening the legal and regulatory framework for mortgage finance. Competition will increase, reducing margins and increasing product variety. As systems mature, lenders will look increasingly down-market, expanding the access to finance for lower income and marginal borrowers.

Commercial and savings banks will continue to be the dominant lenders in most markets. However, specialised lenders are an important source of competition and innovation, particularly where mortgage capital markets are present and can fund non-standard loans. Although Basel II may reduce the use of securitisation, capital market funding will continue to grow through issuance of mortgage bonds and funding of non-traditional loan products and lenders.

What is the downside of this rosy scenario? Many analysts (for example, *The Economist*) point to unsustainably high house prices and the potential for the housing ‘bubble’ to burst. Without a major shock to the broader economy, this result is unlikely, however.

In most countries, there is a strong preference for home ownership, and households are unlikely to sell their houses because they seem over-valued. Although some households have become over-extended and others have invested in condominiums and rental property, they still constitute a small minority of the borrowing public. Mortgage arrears may increase, but are unlikely to lead to a reduction in the supply of mortgage funds or a significant increase in interest rates in the foreseeable future. **TB**

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