The Politics of Housing Finance in Emerging Markets

Mark Boleat

This paper seeks to analyse some of the political reasons why little progress seems to be possible in introducing effective housing finance mechanisms in so many emerging markets, notwithstanding the availability of a great deal of analytical material and expert assistance from the World Bank, other aid agencies and consultants.

The importance of housing finance

The importance of a strong housing finance system in emerging markets is well understood. An efficient system should be capable of reducing the spread between the mortgage rate and the cost of funds from perhaps typically 8% to 15% to somewhere between 2% and 4%. By reducing the cost of funds more people will be better housed and the construction industry will be stimulated. The financial markets should also be widened and deepened. People may be encouraged to use financial institutions who otherwise would not have done so and the formalization of the economy can thereby be facilitated.

Macro conditions for housing finance

A number of macro conditions must apply if an effective housing finance system is to be created. This section simply notes the wider economic and political factors, which are not specific to housing finance –

- Economic conditions, in particular an effective housing finance system cannot operate with high rates of inflation.
- Financial stability.
- Political stability.
- Trust in financial institutions.
- The extent to which economic activity is formal rather than informal.

However, it is worth briefly noting that an effective housing finance system can contribute to the last two conditions being met and, arguably, to political stability.

Micro conditions for housing finance

An effective housing finance system needs a number of building blocks, all of which are required if the system is to be fully effective –

- Properly established and documented land ownership rights.
- Generally accepted principles for valuing properties backed up by appropriately trained personnel.
- The ability of mortgage lenders to realise their mortgage collateral and take steps to recover their debt within a reasonable period.
- Funding from either or both of retail deposits or longer term finance, such as bonds and funds held by insurance companies and pension schemes.
- Generally accepted and properly adhered to underwriting standards.
- Sound prudential regulation of banks.

- Sound regulation of the capital markets if these are being used as a source of funds for house purchase loans.
- An efficient insurance market able to provide life insurance, property insurance and ideally also mortgage payment protection insurance and mortgage guarantee insurance, although the latter two may take some time to develop.

A basic problem – the range of issues

It has been necessary to detail the requirements that must be met for an effective housing finance system to illustrate the basic problem, that is the number of government agencies that must all pull in the same direction. Those agencies typically include –

- The Ministry of Housing, responsible for construction and sometimes for overall policy towards housing finance.
- The Ministry of Finance, responsible for taxation and sometimes the development of the financial system.
- The Ministry of the Economy, where such a ministry exists, which has an overall strategic role in respect of the development of the economy.
- The Ministry of Justice, responsible for land registration issues and arrangements for taking possession.
- The banking regulator.
- The capital markets regulator, where securities are issued to fund mortgage loans.
- The insurance regulator.
- Any specific regulator of the housing market or of the housing finance institutions.
- Any existing state housing agencies.
- Government pension funds, a possible source of funding.

At the best of times this is rather a long list. It is natural in any country for government departments to compete with each other, sometimes fiercely. The more departments that are involved in issues, the more difficult it is to achieve the necessary co-ordination even if it is desired by everyone, and the easier it is for one or two departments to block sensible reforms. For example, even if everything else is in place, if the Central Bank regards mortgage lending as a dangerous activity and does not allow the banks to do it then a successful housing finance market will not develop. Having said this, institutions can work their way round the various constraints. An excellent example is the Housing Development Finance Corporation in India which has operated successfully for a number of years notwithstanding many obstacles, in particular the absence of adequate possession arrangements. Generally, however, strong and effective political leadership, with the full backing of the leadership of the country, is needed to formulate and implement a comprehensive programme to create an efficient housing finance market.

People issues – training, competence and integrity

There are three different people issues that need to be addressed to deal with the housing finance issue. At one level there needs to be proper training for professions such as valuers and regulators. This training is readily available from western sources.

The competence issue is a problem in many countries. Developing an effective housing finance market from nothing requires bold leadership and a high degree of competence.

In many countries, the people at the head of government agencies have been there for a long period of time and have neither the intellectual capacity nor the ability to drive forward the necessary changes. In a number of countries, the heads of these bodies are cronies of the relevant minister.

The question of integrity is important in a number of economies. In some countries there is blatant corruption or the use of undue influence. This is particularly important in housing finance given the long term nature of the business. If the regulator is corrupt then, besides introducing inefficiencies into the system, there is the significant danger than unsound practices will be allowed to continue. This can lead to defaults on securities and the failure of financial institutions which then bring the whole of a housing finance system, and possibly a financial system generally, into disrepute.

Uneven access to international experience

Emerging markets and the aid agencies properly draw on the available international experience. However, one cannot just draw on experience without having people able to explain that experience and draw lessons from it. The fact is that the available expertise does not represent fairly the available experience of housing finance systems. It is necessary to explain a little about housing finance systems to justify this comment.

There are three broad models of housing finance –

- The specialised system in which narrowly defined institutions specialise in mortgage finance. These institutions may rely on some explicit or implicit government subsidy. Such institutions are very strong in only a few countries, particularly Denmark and Germany.
- An open system in which the main mortgage lenders are the retail banks or commercial banks which have retail banking as one of their major activities. This system predominates in most English speaking countries.
- The government managed system in which government agencies play a major role in the operation of the market. In western counties, the most nationalised housing finance market is in the USA where there is government funded insurance of retail deposits, government insurance for a significant part of the mortgage market and government guarantees for mortgage backed securities, which now dominate the overall market. Canada is another country in which there is significant government intervention through the activities, in particular mortgage insurance, of the Canada Mortgage and Housing Corporation.

It is worth noting that over the years there has been a steady shift from systems based on specialised institutions to those based on general banking institutions. Previously specialist mortgage lenders have become more general banks in almost all of the English speaking countries.

A key point is that, almost by definition, there are few experts on open systems because there is nothing to be expert about. By contrast, there is any number of experts on specific systems. There are therefore probably more experts on the German bausparkassen system or on the American secondary market than there are experts on an open housing finance system. Furthermore, because the specialised and government controlled systems are, for perfectly good reasons, under threat, the institutions are very prepared to spend the necessary amounts of money to defend it. Demonstrating how their particular model is being widely adopted in other countries is one means of helping to achieve this.

Two institutions stand out in this respect. The first are the German bausparkassen, which vigorously defend their model in the European Union (to the extent of having an organisation which calls itself the European Federation of Building Societies and which is misleading in the extent to which its describes its membership, as in practice it represents the German and Austrian bausparkassen). The bausparkassen have vigorously sought to promote their model and have succeeded in encouraging governments in a number of central and eastern European countries to set up systems based significantly on their model. This has happened in Slovakia, without great success, and now appears to be happening in Russia.

By far the more important specific agency is Fannie Mae in the USA. Broadly speaking, Fannie Mae, and its sister organisations Freddie Mac and Ginnie Mae, have resulted in the nationalisation of the American housing finance system. Fannie Mae purchases long term loans from mortgage lending institutions and issues securities backed by them. In so doing, it takes an interest rate risk itself. The effect of its activities is to drive down the cost of mortgages such that it becomes uneconomic for portfolio lenders to operate. There is also a huge potential risk to the taxpayer, particularly as there is a general perception that Fannie Mae and Freddie Mac come into the category of "too big to fail".

Fannie Mae is prohibited by its charter from operating outside the USA but nevertheless it has been very energetic in both developed and emerging markets by offering technical assistance, sponsoring seminars and so on.

Domestic vested interests

In most emerging markets, there are a number of interests which could well suffer if an effective housing finance market is created. These can include –

- Those responsible for land registration who may be required to work in a different way or at a different speed or, in some cases, may not be required to work at all. The elimination of land registration fees is one measure which can help a housing finance market develop but might lead to a reduction in the number of people employed.
- State housing banks have a privileged position, generally with access to cheap government funds and enjoying a monopoly position. If private banks are able to compete with them, they could very quickly be out of business.
- State sponsored savings banks. Again, these occupy a privileged financial position. Often, they show little interest in the retail market, a good example being Sberbank, the Russian savings bank, which has 75% of all retail deposits, but virtually no retail loans.
- Departmental jealousies as noted above.

Foreclosure arrangements

The need for adequate foreclosure arrangements is well understood but in many countries it has not been possible to introduce the necessary arrangements. Even in developed economies, it is often argued that lenders should be constrained, if not prohibited, from taking possession and selling their securities when borrowers default. Indeed, it is not uncommon to find lenders being blamed for people defaulting in the first place, that is they lent irresponsibly and they should not be allowed to compound this error by getting their money back.

In emerging markets, there can be a number of different types of issues that have to be addressed –

- The law simply does not allow the lender to take possession.
- The law allows the lender to take possession but not to evict the people living there.
- The law is adequate in every respect but it takes many years to enforce.
- Judicial discretion is so great that lenders do not know where they stand.

It follows that measures to deal with this problem have to go well beyond putting the necessary laws in place but also have to cover the way that laws are administered, judicial discretion and access to the courts.

The lure of securitisation

Fannie Mae has been incredibly successful in promoting its concept around the world. Securitisation is an exciting word and policy makers can be attracted by the thought of skipping the many years of mortgage market development that western countries have had to go through and moving straight to the apparently sophisticated model that at first sight works so effectively in the United States. Securitisation is seen as offering magical benefits, in particular by offering a new source of funds, including from international markets.

In fact, securitisation cannot work unless a number of conditions are met including –

- All the building blocks are in place so that there is adequate mortgage security.
- There is a critical mass of business without which securitisation, as opposed to mortgage bonds, is horribly expensive.
- The institutions securitising mortgage loans have a satisfactory track record in respect of their lending activities.

Sadly, a huge amount of resource has gone into seeking to develop secondary mortgage markets which has been an unnecessary distraction when there has been so much to do to get efficient primary markets in place.

The protection of borrowers

It seems to be inevitable that those responsible for helping to establish a housing finance system in an emerging market spend more time in devising elaborate means of protecting borrowers than they do actually in getting the system to work at all. The effect can easily be to provide protection which is unnecessary and can frustrate the operation of the market. The nature of mortgage loans is such that borrowers do require some protection.

It is particularly important that borrowers are aware of precisely the nature of the contract that they are taking on, in particular whether the rate of interest can be varied and, if so, by what criteria and also the fact that if they do not meet their loan repayments then the property may be taken into possession and sold. In other words, they will lose their home.

However, other than ensuring that borrowers understand this information, it should not be necessary for regulators to get involved in the detail of loan instruments or to require that borrowers are given voluminous amounts of information. In practice, in many countries, regulators have sought to lay down the precise nature of the mortgage instrument, including how the loan amount is to be calculated in relations to incomes, the frequency of loan repayments, arrangements for prepayment of principal and voluminous information requirements, which borrowers probably neither understand nor want.

This overload of information applies also in developed countries. The fact is that it can be easier for regulators to devise these rules and regulations than it is for them to do the more important job of ensuring that a market operates efficiently.

Attacking the political problem

The problems identified in this paper need to be addressed at two different levels. At the international level, it is important that the "silent majority" is properly heard. The World Bank and other aid agencies must play their part in recruiting the necessary specialists who have expertise in markets such as Britain and France and the relevant organisations in those countries must also play their part. Politically, western countries have something to gain if they can be seen to be making a positive contribution towards the development of housing finance markets which are so important in the development of the economies generally. In the case of the countries of central and eastern European and the candidate states of the European Union generally, there is the added political point of influence in the decision taking process in the European Union at a future time.

In emerging markets, the points that might generally be made in addition to the more obvious points are –

- The need for high level political leadership capable of influencing all of the departments and agencies of government.
- As far as possible, concentrate regulation of financial institutions in the central bank and do not create specific regulators.
- Err on the side of simplicity rather than sophistication.
- Keep securitisation in mind when developing regulations but concentrate on getting the primary market working first.
- Concentrate political support and whatever subsidies are available to limited programmes for mortgage indemnity insurance.
- Do not attempt or even think the impossible, such as large scale subsidies which inevitably will go to the better off or forcing lenders to lend to people to whom they should not be lending.
- Do not confuse the development of a housing finance system with the need to provide housing for those unable to house themselves.

- Do not direct or prohibit particular funding arrangements.
- Remember that the best can be the enemy of the good.

****

Mark Boleat is an independent consultant specialising in the handling of public policy issues, particularly in financial markets. He has held the positions of Director General of the Building Societies Association, the Council of Mortgage Lenders and the Association of British Insurers in the UK and Secretary General of the International Housing Finance Union. He has written a number of books on housing finance and was the founder editor of Housing Finance International. In addition to his consultancy work he is a director of a housebuilder, a software company and three life insurance companies in the UK, a member of the Gibraltar Financial Services Commission and a member of the Court of Common Council of the City of London

Mark Boleat
Tel: + 44 7770 441377
Fax: + 44 1923 836682
E-mail: Mark.Boleat@btinternet.com
Website: www.martex.co.uk.boleat