Regulation of Mortgage Lending Institutions

by Mark Boleat

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This paper seeks to provide an overview of the context in which mortgage lending should be supervised. It does not deal in detail with the position in Egypt, but rather describes common practice throughout the world in regulating mortgage lending institutions.

Many countries have years of experience of regulating mortgage markets. That experience has not always been good. Huge mistakes have been made. For example, in the United States, housing finance institutions were forced to borrow short term and lend long term with disastrous consequences when interest rates rose. In every country there should be a culture of learning from experience so that the same mistakes are not repeated and that best practice can be built on. Emerging market economies have the advantage of being able to draw on some of this experience without having to go through it.

Objectives - the wider context

Regulation, like most policy making, is about judgement. There are few absolute rights and wrongs. It is necessary to make a choice between conflicting objectives. In respect of regulating mortgage lending institutions, judgement has to be exercised in respect of the laws and regulations and their application in practice.

In this context, it is important to look at the overall policy objectives of the government and the needs of the country.

Egypt has a higher proportion of informal housing and a lower proportion of home ownership than comparable countries. This is both partly caused by and partly contributes to the lack of an effective housing finance mechanism. Mortgage finance is less developed in Egypt than in other counties at a similar stage of economic development. The limited formal housing finance mechanism prevents many people who should be able to buy houses from doing so. Those that do buy have to use informal and inefficient means that give them less protection than is accorded to home buyers in most countries. For example, many new houses are bought with the assistance of developer finance. This is expensive, with an effective interest rate above what would be a reasonable mortgage rate, and also the home buyer formally obtains title to the property only when the last instalment is paid, whereas in a developed housing finance system the home buyer obtains title as soon as the property is purchased. For developers the system is also inefficient because it ties up their capital.

A thriving housing finance mechanism would also help deepen and broaden the Egyptian financial system generally. People who would not otherwise use formal financial institutions will do use if it helps them improve their housing position.

The general approach to regulation

Public policy on financial regulation should have three broad objectives -

- To ensure the financial soundness of institutions.
- To protect the public.
- To develop the market.

These three aims work in harmony to some extent. The public are protected from losing their savings if there are sound financial institutions and, in the long term, financial markets can develop only if financial institutions are sound. But in the short term the objectives can conflict, in particular seeking to protect the public can threaten the viability of financial institutions or prevent a market from developing.

The necessary judgement must be exercised to ensure that the market is not stifled and that decisions on prudential supervision and protecting the public are taken in the full knowledge of the impact that they will have on the development of the market.

In Britain, we increasingly use the expression that “the best is the enemy of the good”. That is, in the attempt by government to strive for perfection the overall result is often to worsen the position such that it becomes unattractive to provide the good or service. To take an example, in Britain there has for years been a modest industry based around home visits by insurance companies to collect premiums. The government decided that people buying in this way should receive the same protection as people making substantial investments in complicated financial arrangements. Accordingly, the regulation of this business was tightened to such an extent that it became uneconomic and therefore savings institutions stopped providing it. The need for the service has not gone away, just the ability to provide it.

Similarly, it is of course desirable that no-one ever loses their home because of inability to meet repayments on a housing loan through no fault of their own. But if the law makes it impossible for lenders to realise their security, then the effect is not to give this added protection but rather to prevent house purchase loans at reasonable rates of interest being made, and therefore people either have to use alternative means, such as developer finance, which give them even less protection, or are denied access to the market.

Given this background, this paper not only talks about what regulators should do but, as importantly, what they should not do.

If one had to set out an overriding medium term target for mortgage finance in an emerging market, it should be that people should be able to borrow money to buy homes at an interest rate at around three to four percentage points above the cost of funds. In most emerging markets this spread is more like 8 to 15 percentage points whereas in developed markets it is under two percentage points. An effective regulatory system drives down that spread and, at the same time, permits a huge expansion in the mortgage market.

The context within which mortgage finance operates

An effective housing finance mechanism cannot be examined in isolation. It is dependent on a number of other factors which are of much wider importance.

There is a need for financial stability. Housing finance necessarily involves long term loans, and making long term loans in a sound way for both lending institution and borrower is far from easy when interest rates and inflation are high and volatile.

Similarly, general economic stability is important. People will be less inclined to invest in housing if they believe, based on past experience, that their future well-being is uncertain.

There also needs to be a trust in financial institutions and formal methods of finance. If people are reluctant to put what savings they have with formal financial institutions and prefer to borrow from family or friends or not to seek to improve their housing at all then a housing finance mechanism will not easily develop. The point has already been made that housing finance can be a stimulus to developing financial institutions.

A final general point is that individuals and market participants must be confident that they are not at risk from future regulatory and political changes. For example, in Britain for many years it proved impossible to change the laws that had wrecked the market for private rented accommodation because potential landlords believed that an incoming Government would retrospectively impose security of tenure and rent restrictions.

The role of banks

There are a number of different models for housing finance systems. In practice the majority are based on the banking system, either directly or indirectly. Mortgage lending is merely a special type of bank lending. Loans to finance house purchase can be financed by retail deposits or wholesale funds, and the banks have as their business the raising of such funds. It is therefore unwise to exclude the banks from the housing finance system and in most countries they are the most significant lenders. For example, in Britain, specialist retail banks, most of which were formerly called building societies, account for well over half of total house purchase lending with most of the remainder being accounted for by the large multi-purpose banks. In France, the Crédit Agricole is the largest lender. In Germany, the savings banks are the biggest lenders and, in America, the commercial banks, directly and indirectly, are among the biggest lenders. In countries where most lending is done by specialist mortgage banks, these are often owned by the commercial banks (as is the case in Germany) or they are heavily funded, directly or indirectly, by the commercial banks.

In very few countries do regulators stipulate a maximum proportion of a bank's balance sheet that should be in the form of mortgage loans. For building societies in the United Kingdom, there is the opposite stipulation, that is, that loans for house purchase must exceed 75% of the total loan portfolio. If there is a wish to limit mortgage lending by banks for sound prudential reasons then this should be done by capital requirements not by balance sheet controls. If a balance sheet control is used there can be a perverse effect such as banks continuing to make loans for house purchase but without having any mortgage security. Some emerging markets have sought to follow the American Community Reinvestment Act to direct lending to particular areas or types of people. Such directed lending policies are at best risky and need to be carefully managed if they are not to threaten the financial health of the lending institutions or hinder the development of the market. They are wholly inappropriate in the early stages of the development of a housing finance system.

Prudential regulation

Over the last 20 years, there has been significant international harmonisation of the capital adequacy requirements on banking institutions. This has been led through the Basle Committee of Banking Supervisors. The motive behind harmonisation has been that much banking activity is now international and if regulatory arbitrage is to be avoided then it is sensible for the capital adequacy rules in each country to be broadly similar. Although the rules were made to cover banks operating internationally, in practice they have been adopted by many countries for the whole of their banking system and there is now a fair body of generally accepted rules, regulations and best practice. The current rules will be replaced in a few years by what is known as "Basle 2".

There is a recognition among banking regulators that loans secured on residential property occupied by the borrower are more secure than loans generally. This supposition is backed up by a huge amount of empirical evidence from a number of countries. However, this applies only if mortgage loans genuinely do offer better security than other types of loan. In developed countries they do because in effect the loan is secured on the income of the borrower and on the property which can be taken into possession and sold if the borrowed defaults. Mortgage loans qualify for 50% risk weighting, that is they require half the capital backing of loans generally. Under Basle 2, the weight would be reduced even further, to 35%.

Regulators may define the type of loans that qualify for this lower capital backing quite narrowly, such as loans secured on residential property occupied or to be occupied by the borrower where the loan is no more than a set percentage (typically 80%) of the valuation of the property. Loans to developers do not qualify for this lower risk weighting.

The loan-to-value ratio (LTV) is demonstrably a key variable in explaining the likely default rate on a loan portfolio. The rating agency Fitch ICBA has established a relationship between the LTV ratio and expected loss from the experience of six industrialised countries. Broadly speaking, loans with an LTV ratio of between 85% and 90% have an expected loss ratio twice as high as loans with an LTV between 75% and 80% and eight times as high as loans with an LTV ratio of 60% to 65%.

The regulator should also look at the overall risk structure of a lender's loan portfolio in absolute terms and in comparison with banks generally. Among the factors that should be taken into account are:

- Arrangements for ensuring that mortgaged properties are properly valued.
- Lending criteria in respect of factors such as loan to income multiples and track record of borrowers.
- Concentration of risk - by type of borrower, property or location.
- Any guarantees, for example mortgage insurance which compensates lenders should properties taken into possession be sold at a loss, and personal or employer guarantees.
- The track record of the lender.

Regulators also need to monitor the interest rate mismatch. Loans for house purchase are much longer term that most other bank loans. House purchase loans can either be made at fixed rates of interest for the period of the loan or for sub-periods (for example, fixed for five years at a time) or they can be at variable rates with the rate of interest varying according to the cost of funds. There are no prudential grounds for favouring a particular instrument; the regulator's concern should be with managing the interest rate risk.

Provided a bank matches its assets and liabilities then it might seem that it carries no interest rate risk. For example, if a bank makes all of its loans at variable rates and funds these through variable rate deposits it has an exact matching. Similarly, if a bank makes 20 year loans financed by 20 year bonds, then again it has an exact matching.

In practice, the position is rather more complicated. An interest rate risk cannot be entirely eliminated. Fixed rate loans present a risk when interest rates fall. If the borrower has the right to redeem at any time without penalty or with a penalty that does not reflect the loss that the lender would incur, then the lender carries a substantial risk. Regulators should not allow such arrangements but they have applied in many countries as a result of political decisions. If borrowers are not allowed to redeem without penalty, in practice lenders run a risk as borrowers tend to get very annoyed if they are paying a rate of interest of 15% when loans are currently obtainable at 7.5%. Even if the political pressure can be avoided, the bank may incur substantial adverse publicity and may also have a higher level of defaults as some borrowers simply opt to stop paying what they see as a high rate of interest and believe that they can refinance at a lower rate.

In practice, few banks in industrialised countries commit themselves to long term fixed rate loans for precisely this reason. In those countries where this does happen, interest rates generally have had a history of greater stability which allows fixed rate loans to be made with more confidence.

Banks can mitigate this risk by fixing rates for say five years at a time, the loans being backed by fixed five year deposits or bonds. Thus, a 20 year loan can be made but with a new rate being fixed every five years. This can expose borrowers to substantial risk if loan rates have increased significantly during the period for which the rate was fixed.

With variable rate loans the incidence of default is increased if interest rates rise rapidly as borrowers may be unable or unwilling to meet the higher repayments. Again, a stable economy can reduce this risk.

It might be obvious that lenders should not finance long term fixed rate loans with variable rate deposits because in the event of rising short term rates they will incur significant losses. It was this factor that brought down the American thrift industry.

Related to interest rate risk is liquidity risk where funding is on a short term basis and loans are longer term. A lending institution, particularly in countries where the banking system generally is not strong, can be in difficulty if it loses deposits used to fund long term loans. This is an area where the Government may be able to provide some assistance through providing liquidity to the market and it is also an area where secondary market activity can help. The prudential regulator needs to take account of what the lender itself is doing to limit liquidity risk as well as the effectiveness of secondary market and other support arrangements.

Special issues in emerging markets

The techniques described above cannot easily be applied in newly developing mortgage markets, particular where much economic activity is informal. Specifically -

- Mortgage security may not be easily realisable.
- The property valuation function may not be well developed.
- Income may not be easily verifiable.

- Neither lenders nor borrowers have a track record.
- There is no reliable aggregate data.

Supervisors and policy makers generally can compensate for these problems through a combination of -

- Being cautious until experience allows some liberalisation - but not at the expense of stifling the market.
- Using international data where it is available - the effect of differing LTV ratios on likely loss seems broadly similar in all developed countries - it is unlikely to be significantly different in emerging markets.
- Encouraging the development of a valuing profession.
- Working with other parts of government to secure at least a common understanding of how mortgage security can be realised.
- Taking responsibility for developing a database of housing information.

Mortgage insurance is capable of playing a major part in overcoming the problems merging markets face. Initially, mortgage insurance may need to be government run but experience shows that it is difficult for governments to disengage from this market (they have yet to do so in America or Canada). A government run mortgage insurance system must be carefully structured and managed if it is not to become costly and a method of subsidising the middle classes (like most subsidy systems). However, mortgage insurance is managed it must be properly priced using sound actuarial techniques, widely available so as to spread the risk and properly regulated. A failure of mortgage insurance arrangements can bring down a housing finance system.

Secondary mortgage activity

The expressions "secondary mortgage market" and "securitisation" tend to be used rather loosely and can mean different things to different people. Some also see secondary markets as having some magical quality either of being a source of funds in themselves or of being able to compensate fully for the deficiencies of a primary mortgage market.

Some form of secondary market activity is evident in many industrialised countries although in most it is only on a modest scale. The reality is that in the vast majority of countries, developed and emerging, mortgage loans are made by banking institutions and generally stay on the balance sheets of those institutions.

The overriding rationale for secondary market activity is that the three components of the mortgage lending function - originating loans, servicing loans and holding loans are very different and require different skills and capital. A secondary market allows institutions to specialise in what they do best.

There are a number of different types of secondary mortgage market activity:

The simplest is the use of covered or mortgage bonds. These are on-balance sheet obligation of the issuing institution. A bond is issued, fully backed by the issuing institution, but there is additional security in that if that institution is unable to meet the obligations under the bond then the mortgage assets which have been used to back it can be used as collateral. This method of financing is most developed in Germany and Denmark but has recently been introduced in a number of other countries. As the loans remain on the balance sheet of the lending institution they require the same capital backing as any other loans This technique cannot be used as a means of getting loans off the balance sheet for capital adequacy purposes.

A second form of secondary market activity is where a lender sells a loan portfolio to another institution, perhaps an investor or perhaps another lender. Here, everything is transferred including the risk and the loans can then properly not be counted for the purpose of assessing capital adequacy.

A variation of this is where a mortgage originator originates loans directly on to the balance sheet of an investing institution.

The expression "securitisation" is usually used to refer to a more sophisticated technique by which securities are issued backed by a pool of mortgage loans. Generally, those loans are placed in a special purpose vehicle established by a lender or by a third party in respect of a number of lenders.

To enhance the security, the individual loans may have some form of insurance and the whole loan package may also be covered by insurance. In the case of part of the American secondary mortgage market there is also a government guarantee which means, in effect, that the securities are government backed and carry a risk weighting accordingly.[1]

The resulting securities should carry a higher rate of interest than government securities but lower than other bonds because of the high security which they offer. The spread over the government bond rate will depend on the security offered to investors and other factors such as the liquidity of the securities which in turn depends on the size of the market. This leads to an important point about mortgage backed securities. The fixed costs of mortgage backed securities are very high and need to be widely spread if the technique is to be economic. A mortgage backed securities market can be viable only if there is a critical mass of business sufficient to cover these fixed costs and to provide the liquidity in the market.

Mortgage backed securities may be particularly attractive to investing institutions that want long term assets like mortgage loans that yield more than government securities but which do not have the mechanisms to make and service loans. The normal regulatory requirement is that mortgage backed securities carry a 50% risk weighting like mortgage loans but only if a number of conditions are met, in particular that the securities would ultimately allow holders to acquire the legal title to the property and to realise it in the event of default and that the mortgage loans themselves qualify for the 50% risk weighting. Where the securities are backed by the government or a bank or any other organisation then a lower risk weighting may be appropriate. In practice this is often the case, although the risk weighting reflects the primary security with the mortgage aspect being more relevant to the cash flow than to the security.

Principles for secondary market regulation

Where securities are issued then they must be regulated by the appropriate capital markets regulator. Where institutions that are not classified as banks are making loans then they need to be regulated, perhaps by the banking regulator but possibly by the securities regulator or a specific mortgage market regulator. Non-bank mortgage lenders should not be subject to the same capital requirements as banks - as those requirements are primarily aimed at protecting depositors. The banking regulator must remain responsible for prudential supervision of banks in respect of mortgage loans that are then sold, used as security or are securitised.

Several points emerge from this -

- The various regulators should work in harmony.
- Rules aimed at protecting borrowers (for example information requirements) should apply to all loans regardless of the lender.
- There should be no scope for regulatory arbitrage. For example, there is no point in allowing mortgage lenders to securitise part of their loan portfolio so as to reduce the capital requirements they have for that portfolio if they are then allowed to guarantee the securities.
- There should be some regulatory standardisation. If both banks and non banks are permitted to issue mortgage backed securities, and there is no reason why they should not, then it is important that the same rules should apply to the loans eligible for securitisation, for example in respect to the maximum LTV ratio.

Insurance can play an important part in facilitating secondary market activity - as it can for primary market activity. Mortgage insurance institutions can help determine the criteria for a particular class of "safe" mortgage loans which may then be eligible for securitisation. This insurance can also give comfort to the regulator.

Capital requirement for secondary market activity by banks

Where banks retain the risk on mortgage loans then those loans should have the same capital backing as if they had not been securitised or sold. This applies for example if the bank guarantees the loans or the securities. In this case secondary market activity is a form of funding not of capital management. Where mortgage loans have effectively been removed from the balance sheet of a bank such that it carries no risk then it is reasonable that the bank should not be required to hold any capital against these assets. Regulators must ensure that the bank really does retain no risk and therefore that the securities are structured appropriately. However, an issuing bank will retain some risk if it continues to service loans. For example, if a bank fails to service loans correctly, the likelihood of default will be increased and the holders of the securities will suffer losses. If it can be determined that this is the fault of the bank for the way that it serviced loans then it will be liable for any such losses under the terms of the servicing agreement between it and the institution issuing the securities.

In a few western countries, the secondary mortgage market has become very sophisticated with multi-class securities being issued with differing risk profiles. However, the broad principle remains that the capital requirements must reflect the risk. For example, it might seem attractive for a bank to sell 90% of a loan portfolio, retaining just 10% but absorbing the first 10% of any losses. Here, the regulator would properly require full capital backing as, in practice, the bank retains all of the risk.

Protection of home buyers

In addition to seeking to regulate mortgage lending to ensure that lending institutions stay solvent, policy makers also have a duty to protect the public from certain practices. Whether the institution regulating mortgages or another government department should have this responsibility is a separate matter and for each country to resolve in its own way. It is of course helpful that various regulators should be seen to be working together.

There is a general tendency for regulators to go too far to seek to protect home buyers as a result of which the housing finance market is not fully developed. The best protection for the public results from a combination of a competitive marketplace and trusted institutions.

While regulators may be tempted to set specific requirements in respect to LTV ratios, loan-to-income ratios, the terms on which mortgage loans should be made and so on, it is far better that they confine themselves to ensuring that borrowers fully understand what they are taking on, particularly any interest rate risk and the fact that if they fail to repay their loan they will lose their home.

The issue of realising the mortgage security is critical. If, in practice, lenders are not able to take possession and to realise the security within a reasonable period of time then they and the regulator will not treat that loan as being a particularly safe loan meriting a lower capital requirement or a lower rate of interest. Seeking to protect the public by seeking to prevent lenders realising their collateral is a form of massive income transfer from people who do not default on loans to the very small number who do.

It is also important that there is full disclosure of relevant information to those who fund mortgage loans, particularly where this is done through specific instruments such as mortgage bonds.

What policy makers should not do

This paper has covered to some extent already the things that regulators should not do as well as that which they should do. It is helpful to summarise these points.

Policy makers should not force lenders to lend at rates of interest which are not sufficient to cover the cost of funds, the cost of administration and the return required on capital. Interest rate controls are the quickest way to stifle the development of the mortgage market. There are almost no circumstances in which they can be justified.

Similarly, lenders should not be forced to lend to uncreditworthy borrowers, in particular people with marginal incomes in respect of their ability to purchase a house or people with poor credit histories.

Lenders should also not be required to fund social housing projects at a subsidised rate of interest, although they can play an important role in delivering government subsidy programmes.

Regulators should not seek to become experts on particular loan instruments or institutional structures nor should they seek to shape how the mortgage market should look. Forcing all lending into particular types of narrowly defined institutions might be tidy administratively but has no merit for any other purpose.

Institutional dynamics

It is helpful to conclude with a short section on the dynamics of financial supervision as the laws which apply to this seem universal.

There is a natural tendency for all regulators in all countries to over-regulate. The effect is generally to stifle the market and, in some cases, it can be disastrous for the market. For example, American regulators believed they were protecting home buyers by not allowing thrift institutions to make variable rate loans even though they had variable rate deposits. The result was that some home buyers were protected but at the expense of the thrift industry itself running into serious trouble with a huge bail out from the government, that is the tax payer. In those countries where the rights of house purchase lenders to take possession are restricted the effect is to stifle the development of the market.

There is also a tendency for regulation to expand ever outwards. This follows from a natural law of business that wherever one draws the line there is always somebody just on the other side of it. Regulation therefore may start out with mortgage lenders and then can spread to various intermediaries and advisers.

Regulation is never an easy task. The ideal regulator needs to be reasonably independent of the government so that ministers are not able to lean on him to do things which make no commercial sense for the lenders, for example lending at uneconomic rates of interest. However, the regulator should not be single-mindedly concerned with protecting the financial health of the institutions he regulates. The easiest way to do this is to stop them making any loans at all. The regulator must therefore be a willing party in the overall objective of developing an efficient mortgage market.

The problems of regulatory creep and overkill can be deterred if a rigorous policy making process is used which includes some form of cost benefit analysis. Interest groups also have an important role to play. In emerging markets in particular there is a need for strong trade associations of market participants and potential market participants who can help ensure that the government receives a good input into the policy making process and, most importantly, one that does not represent a particular, perhaps favoured, lender but rather the whole marketplace. It is also important that the interests of consumers are properly considered in developing a regulatory framework. This is far from easy as consumers will not do this spontaneously, but there are various techniques for establishing the views of consumers and also for attempting to analyse what their interests should be. As in other aspects, this is an area where there is significant international experience.

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Biographical note

Mark Boleat has over 25 years' experience in trade associations in the housing and finance sectors in Britain. Between 1986 and 1993 he was Director General of the Building Societies Association. During this time he was responsible for a demerger which created the Council of Mortgage Lenders, of which he was also Director General. He was Secretary General of the International Housing Finance Union and Managing Director of the European Federation of Building Societies from 1986 to 1989. From 1993 to 1999 he was Director General of the Association of British Insurers, the largest trade association in Britain.

He has chaired one of the largest housing associations (organisations which provide subsidized rental housing) in Britain and for five years was a member of the Board of the Housing Corporation, which funds as regulates housing associations.

Mark Boleat is the author of the first ever study of housing finance at the international level *National Housing Finance Systems: A Comparative Study* and he was the founder editor of *Housing Finance International*. He has undertaken consultancy work on housing finance for the World Bank, the OECD, the United Nations and national governments.

Mark Boleat also holds a number of directorships. He is a director of Countryside Properties (a large British housebuilder and developer) and the Comino Group (a software company). He is also a member of the Gibraltar Financial Services Commission, the Court of Common Council of the City of London and the National Consumer Council.

He is the principal of Boleat Consulting, which provides services to trade associations and government agencies, particularly in the housing and financial markets. He has published a number of books on trade associations and the public policy process.

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[1] [Editor: Ginnie Mae carries a full faith and credit guarantee of the US government. Ginnie Mae securities have a 0% risk weight. Fannie Mae and Freddie Mac do not have US government guarantees but are government-sponsored enterprises with "implicit" guarantees. Their securities carry a 20% risk weight.]