International Union for Housing Finance

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NEWSLETTER *December 2005*

Thanks to HDFC and welcome to the new *Newsletter*

By Adrian Coles, Secretary General, IUHF

My first very pleasant duty in this new edition of the *IUHF Newsletter* is to thank the Housing Development Finance Corporation (of India) for very kindly hosting the recent meeting of the Executive Committee of the International Union. The Committee were almost overwhelmed by the strength of the welcome shown by HDFC, the arrangements put in place for the meeting and the friendliness of the hosts. Included in the meeting arrangements were a tour of the very vibrant construction sector in India – with visits to various suburban construction sites on the edges of New Delhi – and a conference on the Indian economy and housing market, with a number of speakers able to illustrate the very rapid changes taking place in India. Once again, many thanks to HDFC.

This seems to be a bumper year-end edition of the *Newsletter*. I am extremely grateful to all of the members that have made a contribution. The *Newsletter* starts with a review of the recent UN Economic Commission for Europe study into models of housing finance in central Europe. The article describes the range of funding options available to newly formed lenders and analyses the role of government.

I am then very pleased to thank the United Kingdom's Co-operative College for permission to re-produce articles from the UK journal *Co-operative News*. A series of articles in that journal recently examined co-operative ventures in Tanzania, Kenya and Uganda. Judicious editing of these articles has left readers of this *Newsletter* with a single article looking at the contributions made by co-operative financial institutions in developing some of the most deprived areas of the world.

Next, our regular correspondent from the USA, Alex Pollock has prepared an article suggesting that perpetual government sponsored enterprises should be not be in existence; rather every GSE should have a sunset clause forcing legislators to examine every now and again whether the institution should continue in existence. Alex notes that GSEs often grow in rapid and unpredictable ways and that limited-life charters put reformers in a much stronger position as the expiration date approaches.

Next we congratulate the Government Housing Bank of Thailand, which has won all three Best State Enterprise Awards in its country in a single year. We have a picture of the President of the Bank receiving the Bank's award from the Prime Minister of Thailand.

Christian König of the European Federation of Building Societies in Brussels is our next correspondent. He looks at the European Commission's attempts to evaluate the costs and benefits of a more integrated EU mortgage market. He is critical of EU sponsored research in this area and argues that the 25 mortgage markets in Europe are much more differentiated than the consultants used by the EU seem to think.

We then move on to a couple of articles on the new capital adequacy regime. Capital adequacy regulation in India is moving in the wrong direction according to Renu Karnad, Executive Director of HDFC in India, and First Deputy President of the IUHF. She says that concerns about the implementation of regulations on operational risk, the low penetration of ratings and poorly developed information systems may all be challenging for some financial institutions. There is also a lack of harmonisation between different regulators for different institutions. In contrast, Simon Walley, Deputy Secretary General of the European Mortgage Federation analyses the beginning of the implementation of Basel II in the European Union – the first jurisdiction in the world to pass the necessary legislation to put the Basel framework in place. Mr Walley believes that the new risk based system is clearly a step forward. Our next article stays with Europe as we reproduce some basic data on European mortgage markets from the European Mortgage Federation's annual publication *Hypostat*.

Our final article comes from the USA. Any one looking for an up-to-date analysis of the economic situation facing US mortgage lenders need go no further than the work prepared by Orawin Velz and Doug Duncan at the Mortgage Bankers Association (of America). Their central forecast is that the housing market in the States will cool modestly in the next year or so.

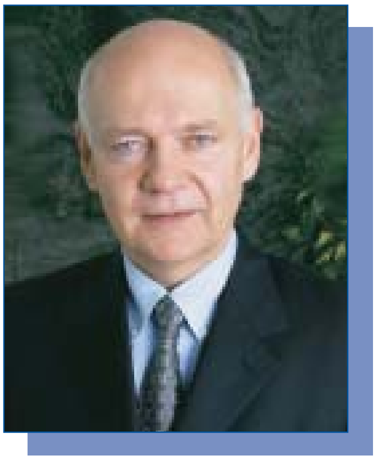
Housing Finance Systems for Countries in Transition: Principles and Examples

By Herbert G. Pfeiffer, Member of the Board of Management
First Building Savings Bank Slovakia

A recent UN Economic Commission for Europe study into the models of housing finance systems provides central European leaders with a freeze-frame look – 15 years after abandoning a central-planned economy – at the status of transition. *Housing Finance Systems for Countries in Transition – Principles and Examples* is designed to help decision-makers better understand housing policies, and which finance systems could be applied in given conditions.

International experts, representing Western Europe, USA, and Central Europe, focused on three private housing finance instruments: the Bausparkassen system, a contractual savings scheme; the Danish mortgage bond technique; and the American variety of MBS (mortgage-backed securities system). The study establishes evaluation criteria and makes recommendations for the most practicable systems in transforming economies.

It draws on experience from the most advanced economies of the various financing techniques, and concludes that, given the heterogeneous experience of these countries, none of these systems can simply be copied. However, properly adapted to local conditions they are likely to help in implementing new solutions and deserve a closer look. It's the authors' view that a pan-European system of applied criteria should exist. But this is acknowledged as being a long-term goal, while instilling a greater degree of uniformity on how data are collected and evaluated is a more immediate, more 'do-able' objective.



Herbert Pfeiffer

Contractual Savings

Looking first at the contractual savings Bausparkassen system, this offers a dedicated loan-linked savings schemes, and among the transition countries, is most advanced in the Czech Republic, and Slovakia. It links a phase of contractual savings remunerated below market interest rates to the promise of a housing loan, with the interest rate fixed at a bottom-of-the-market rate. Originating in Britain over 200 years ago, Bausparkassen were founded as mutual self-help organizations that flourished in response to the poor housing conditions following WWII for lower- and middle-income groups. These "savings communities" allowed the participants to save regularly and to receive a loan according to predetermined queuing rules.

Bausparkassen soon specialized in loans secured by second-ranked mortgages and established the 'division of labour' among them, with commercial banks, or mortgage banks offering home financing secured through first-ranked mortgages. After WWII, Germany's government promoted the Bauspar system in order to stimulate housing when there was a massive shortage.

Mortgage Bonds

In Denmark, mortgage bonds developed differently. Copied from an early 19th century German model, Denmark's mortgage credit system responded to a capital shortage for long-term loans for housing after WWII. Weak legislation and regionally fragmented capital markets restrained the conversion of property into liquid funds, plus government was unable to underwrite such initiatives.

The mortgage credit system was introduced in Denmark as an intermediary between the individual debtor (owner of the property) and the creditor (or investor). This intermediary was an association of borrowers that accepted joint liability for each other's loans. Acceptance of this mutual solidarity improved the creditworthiness of every borrower. As an association they could pool the credit demands of individual borrowers and issue bonds to the investors in order to refinance the loans. These bonds were covered by the mortgages of individual debtors. In addition, these associations could accumulate own funds, which served as a cover for their issuance of bonds. Gradually, they transformed themselves into mortgage banks.

Secondary Market

The U.S. secondary mortgage market emerged in the 1970s as a method of selling mortgage loans in order to reduce both the interest rate and liquidity risk associated with fixed-rate mortgage lending. A secondary market involves the sale of mortgage loans (or loan portfolios) or MBS (mortgage-backed securities system) backed by specific pools of mortgages. In effect, it involves the transfer of the risks and ownership of mortgage loans to a third party. The loans may be sold to separately capitalized institutions called conduits or through other special purpose vehicles (SPV) which raise funds through the issuance of securities collateralized by the loans.

Provision of payment guarantees with the securities issued by the Government Sponsored Enterprises (GSE) has facilitated investor acceptance of these securities. The US federal government either explicitly or implicitly guarantees these institutions. Government National Mortgage Association (GNMA) or Ginnie Mae guarantees pools of loans for mortgage banks. These loans, targeted towards lower/moderate income buyers, are issued by the Federal Housing Administration (FHA).

All these techniques are being marketed intensively in the transforming economies of the CEE by banks and government-sponsored entities like the US MBS institutions. However, Fannie Mae decided recently to disengage from future international advisory and training activities, based on arguments put forward by Secretary Alphonso Jackson of the US Department of Housing and Urban Development before the Committee on Banking, Housing and Urban Affairs.

Role of Government

Government's capacity for supporting housing finance and which measures it should apply needs to be clearly defined. In principle, subsidy schemes should be designed both to improve the nation's social goals and to support the development of the private market. The debate should not be focused on the amount of the subsidy but also on its effectiveness in meeting the Government's goals for housing. After the first steps in the transition process have been accomplished, the question of how to increase affordability of housing gains is of importance for policy makers and it is the task of Governments to decide whether and to what degree different housing finance instruments should enjoy State support.

The UNECE report stresses the strong track record of all three models. That places responsibility on the region's various ministers of finance, construction and development and economy to be thorough in investigating the various systems. Every national housing system is the result of specific circumstances, such as macroeconomic conditions, banking regulations, size of banking system, taxation, subsidy programs and the structure of the housing market. These are the factors that decision-makers need to look at in their approach to bank- and capital market-based mortgage loan delivery.

Experience in the EU, too, shows that the introduction of functional housing finance markets provides large external benefits to the national economy. These include a surge in employment in the construction industry and related sectors, more efficient property development, greater labour mobility, progress in capital market development, more efficient allocation of resources and lower macroeconomic volatility. In order to benefit from these positive effects, emphasis needs to be placed on the legal, institutional and macroeconomic framework. As soon as functioning and reliable framework conditions are in place, financing techniques will emerge, and borrowers and lenders will be able to make informed decisions on the risks inherent in long-term obligations.

Macroeconomic stability remains the unconditional and absolute prerequisite for housing finance to work effectively for governments in providing economic stimulus for lenders and borrowers in the market and, as a fundamental objective, to increase the percentage of private ownership. A volatile environment disproportionately affects long-term oriented housing finance systems. Volatile inflation rates imply high interest rates, which confine market-based mortgage financing to high-income households. Furthermore, governments are likely to take a dominant role in housing finance because of the widespread inability to afford mortgage financing and income inequalities.

As a result, the authors conclude that housing finance systems will most likely remain small and become fragmented into uncoordinated and subsidized administrative programs. Moreover, low levels of domestic savings will lead to housing finance systems being dependent on central bank refinancing and/or international borrowing. This stresses the key importance of savings.

In this context, governments need to closely monitor three distinct policy dimensions that influence access to housing. These are: the price of the housing units relative to purchasing power, the total cost of mortgage borrowing (including all costs of funding the mortgage loan as well as taxes and fees to be paid by borrowers) and the subsidy. Specifically, this means the financial, tax, regulatory and production channels through which a Government can subsidize some types of housing (explicitly or implicitly).

Working in tandem with macroeconomic stability is sound legislation, which also underpins sound institutions, lending activities (of banks and other housing finance entities) and a thriving housing finance market. As well as protecting property rights and enabling clear registered title to land and the registration of a mortgage in the land register, legislation should allow rapid foreclosure. If, for example, a land register system does not exist or is only fragmented, banks can expect long delays in foreclosures, which, of course, will deter them from lending. A developed housing finance sector also requires strong institutions that guarantee embedded rights to the title and the mortgage and enforcement of rights.

The authors suggest the first step toward establishing such a framework is the development or restructuring of institutions and policies in order to facilitate the role of private and non-profit lenders and developers in expanding the low- and middle-income housing supply. Also important is the provision of education and training to consumers and producers aimed at improving the operation of the housing finance industry. The second step should emphasize the provision of subsidies for well-defined purposes and simultaneous improvement of the regulatory system in different supply markets (land, finance and infrastructure) to allow more households to acquire authorized and sustainable housing. If governments fail to encourage the housing construction and savings industries, housing supply cannot respond to price signals, and higher income subsidies will not lead to better housing.

For any particular country, it is advisable to have more than just one housing finance scheme in place in order to mobilize the maximum amount of funds dedicated to housing. Each system assumes a certain function within the market so that systems complement one another. As well as satisfying people's basic desire for home ownership, housing finance systems can work effectively for both deposit takers as Bausparen and mortgage banks, as both are targeted to different market segments on the refinancing side of the business. The savings banks are mobilizing funds from individuals while mortgage banks/MBS focus largely on funds from legal entities.

Conclusion

The study concludes that how far along in the transformation process the country is should be decisive for the selected housing finance technique. When the capital market does not work sufficiently, the promotion of a savings technique like Bausparen is the first step to set up long-term lender/borrower relations. Bausparen improves access to loans for low- and middle-income groups, as the saver proves, by being willing and able to save, their capability to manage the loan repayment.

As mortgage banks are not prepared to offer small loans without mortgage, Bausparen can best meet the huge demand for small reconstruction loans. Bausparen prefers a stable inflation rate, plus the number of savers cannot be declining year-on-year so as to manage the liquidity risk. Short-term deposits are being transformed into long-term loans; hence the 'rentability' of savings is important for a steady flow of refinancing resources. The attractiveness of the technique is a function of the 'rentability' of the savings and the availability of loans.

Mortgage financing can mobilize huge financial volumes when institutional investors are available. The mortgage bond is a very safe investment certificate that can be sold easily on the capital market. Meanwhile, mortgage loans (with matching maturity) are refinanced by mortgage bonds.

A prerequisite of a secondary mortgage market is a perfectly functioning primary mortgage market – and one that's big enough to meet the requirements of institutional investors and the high demands of the loan processing and the underwriting procedures. Fannie Mae has been working on the standardization of these procedures since 1930. A SMM requires a mature market economy.

All governments, especially in developed economies, were and are subsidizing housing intensively by promoting savings, by paying interest rate subsidies, by deducting the interest for housing loans from income tax statements and by granting explicit and implicit state guarantees.

The report provides a risk/benefit analysis for lenders and borrowers and governments, by putting together all relevant criteria for evaluating a housing finance technique from the perspective of the borrower, the lender and the government. The decisive criterion is how effectively funds can be mobilized under a certain legal framework, capital market and demand-oriented conditions.

The study is available for downloading at:
www.unece.org/env/hs/prgm/housing_modern_managmt/hsg_finance/housingfinance.pdf

The Co-operative Movement and Financial Services in East Africa

By Stirling Smith, Freelance Consultant for the ILO and Associate of the Co-operative College

Stirling Smith, of the UK's Co-operative College, visited East Africa in August on behalf of the International Labour Organisation, to study how co-operatives and trade unions can help to organise the very poorest workers in the 'informal economy' where there is no regular work or contract of employment.

This article covers the financial services element of the four reports which Stirling filed during his visit. The IUHF is grateful to the UK's *Co-operative News* for permission to reproduce this article.

Democracy – credit union members gather outside for one of their regular meetings.

Fifty dollars goes a long way in Tanzania

Dar es Salaam, Tanzania's capital is crowded and polluted, a world away from the peace and greenery of the coffee growing districts. But what it does have in common is poverty. Most people scrape a living as petty traders, re-cycling metal, selling vegetables from little stores, selling food and drinks. This is a hand to mouth existence. Having a shack, even one that looks as if a good push would topple it over, can actually mean a huge step up in turnover. Acquiring a charcoal stove to cook food for sale can mean enough income to send your child to school. But where to get the $50 to pay for such an investment? The poor have no property to put up as collateral. A bank won't look at them. Here, Savings and Credit Co-operatives (SACCOs), which are what credit unions are called in this part of Africa, are a lifeline. You join, save a bit, and can get up to three or four times your savings as a loan. Fifty to a hundred dollars is the average size of a loan.

Where do the SACCOs get the money? In the case of the projects I saw, the answer was a revolving fund from the International Labour Organisation, the United Nations Agency with responsibility for co-operatives. This has limited funds, but other sources include Rabobank, the Dutch co-operative bank, which has set up a subsidiary in Tanzania, purely to provide this kind of micro-finance.

This is not charity. People pay high interest on loans, and SACCOs have insurance against bad payers. But the small number of members and their close association, tends to ensure that loans are paid off.

Credit + support = a better life in Kenya

Agricultural co-operatives were established, mainly for marketing purposes, when Kenya was a British colony and the co-op sector is huge. It is estimated that it contributes 45% of GDP and that six million people are members, out of a population of 30 million.

But, as I found in Tanzania, co-operatives have had a long history of government interference, followed by neglect in the 1980s and 1990s. As the World Bank forced privatisation and liberalisation on Africa, through 'structural adjustment programmes', the movement went into a decline. The current government is very pro co-ops, with a lot of support for co-operative development. But many in the movement think the balance between support and interference is still not right.

Farmers' co-operatives are active in the coffee and dairy sectors. There is a successful Co-operative Insurance Company and a thriving Co-operative Bank.

Today, Credit Unions, known as Savings and Credit Co-operatives, or SACCOs, are the most dynamic and successful part of the movement. Their apex body, KUSCCO (Kenya Union of Savings and Credit Co-operatives Ltd) is very well run and takes its responsibilities to promote co-operation, very seriously. KUSCCO has started an insurance agency, helps members with housing and has launched a village bank to mobilise lower levels of savings. This is an experiment, just one branch in an area about an hour from Nairobi.

Conventional banks, including the Co-operative Bank of Kenya, require a minimum deposit of 5,000 Kenyan shillings (KSH). The KUSASA (short for KUSCCO SACCO Savings Account) accepts new deposits of just 200 shillings (the exchange rate is £1 = 100 shillings). This enables very small self help groups to start saving – and individuals of course. At the moment, an individual or group with any cash is vulnerable to theft - often violent. The village bank does much more. It has an customer relations officer, who provides support for the groups, including training, and negotiates with the authorities and stops them being cheated when they purchase supplies.

In some ways, the village bank is similar to the Raiffeisen banks which sprang up in the 19th century and were strongly associated with the Roman Catholic church. It shares some characteristics with the recently established Venezuelan Women's Development Bank (Banmujer), which stresses loans to set up co-operatives, and provides crucial support to groups.

It only cost £100,000 to set up and run the village bank, an amount supplied by KUSCCO and SACCOs in the area. But it is soundly based, as KUSCCO conducted a proper feasibility study and exercised due diligence. It will be in profit by the end of 2006. KUSCCO would like to set up more.

Co-operatives in The Pearl of Africa: Uganda

It was Winston Churchill who called Uganda "the pearl of Africa". The climate is pleasant and the soil very fertile. There were years of chaos during and after the rule of Idi Amin. While Uganda has been relatively stable since 1986, there is an armed group in the north, the Lord's Resistance Army, which forcibly recruits children as young as ten and forces them to kill and mutilate opponents to bits. The country is only just making tentative steps back to multi party democracy.

Most of the old co-operative movement collapsed during the years of chaos and then an extreme period of "economic liberalisation" – privatisation and de-regulation. These were bad years for any kind of social movement arguing that the free market was not the solution to all problems. (A recent report from the International Confederation of Free Trade Unions was entitled *Uganda: a government at the service of employers*).

A few coffee co-operatives survive, but like all the other countries in the region, Savings and Credit Co-operatives (SACCOs) which we would call credit

Clean up – showers and toilets in Gikomba market in Nairobi provided by a co-op.

unions, are the fastest growing and most successful part of the co-operative movement. They are an important way of providing savings vehicles for people - usually under 10% of people have bank accounts. Membership can be very small - I visited some SACCOs with less than 30 members.

No electricity? Switch on with your SACCO

Right on the border with Kenya, after a six hour drive on a road that was more pot holes than road, small SACCOs are trying to provide jobs and at the same time vital rural services. An example: there are very few houses with an electricity supply, so people use car batteries to power lights and fridges, if they are lucky enough to have one. But how to charge the batteries? Step forward the SACCO, which loaned a young man, an orphan, to run a business re-charging batteries. A job for him - and the alternative was probably going to the nearest big city and insecure work - and a service for the community.

Rather than government run co-operatives, what Uganda now needs are sources of credit to feed into SACCOs and the right kinds of training for their members. It is especially important to start promoting SACCOs in rural areas. It also needs strong member based movements to take on the autocratic government - the darling of international donors, including unfortunately the UK's own Department for International Development (DFID), who seem happy to overlook the intolerance of workers' rights.

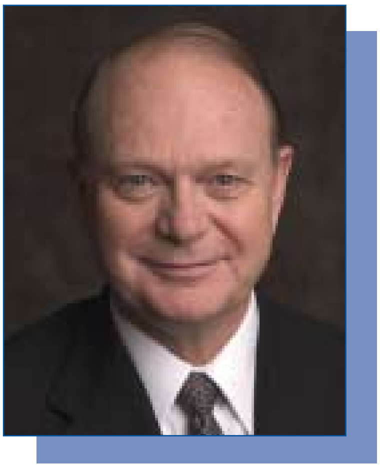
More information from Stirling Smith at the Co-operative College: **StirlingS@co-op.ac.uk**

Revoke All Perpetual GSE Charters

By Alex J. Pollock, Resident Fellow at the American Enterprise Institute

Today's government-sponsored enterprises (GSEs), including Fannie Mae, Freddie Mac and the Federal Home Loan Banks, have perpetual charters. This is a mistake. History teaches an essential lesson: GSEs, if they are created at all, should always have limited-life charters and never be granted perpetual ones.

GSE charters grant them privileges and confer upon their shareholders enormous economic benefits. As 19th century US President Andrew Jackson wrote, "Every monopoly and all exclusive privileges are granted at the expense of the public." These privileges should not be granted forever.



Alex J. Pollock

A charter that expires and requires reauthorization gives society a chance to reconsider whether the grant of special privileges is still warranted. Every GSE creates contingent liabilities for taxpayers. Do the taxpayers think the GSE is still worth it? Every GSE represents some kind of arrangement with the government. Maybe the respective benefits and costs have become skewed and need to be restructured. A limited-life charter gives the government a chance to cut a new deal.

GSEs often grow in unintended ways, developing political and economic power, reaping monopoly (or duopoly) profits, and creating market distortions. Limited-life charters put reformers in a much stronger position as the expiration date approaches.

Consider the substantial difficulty involved in moving legislation to reform the regulation of Fannie Mae and Freddie Mac. In spite of the opportunity presented by their acutely embarrassing accounting scandals involving many billions of dollars and the missteps which caused both of their top managements to be forced out, legislative action may end up stalemated.

Think how different the situation would be if Fannie and Freddie, following the American historical tradition, had been given twenty-year charters. Fannie's current charter dates from 1968. Assuming it had been renewed in 1988, it would have expired again in 2008. Freddie's current charter dates from 1989, so would be expiring in 2009.

If these GSEs were contemplating charter expiration and potential automatic privatization in just three or four years — a heartbeat in historical time — the negotiations over GSE regulation reform would have an altogether different tone, and the chance to enact meaningful reform would be greatly enhanced.

Each GSE is created in the particular circumstances of some historical moment, with the GSE as an answer — real or perceived — to specific economic and political issues of the time. Such was the case for the Federal Home Loan Banks (FHLBs) in 1932, for Fannie Mae in 1938, and for Freddie Mac in 1970.

None of the circumstances which prompted the creation of America's current GSEs still exist. The assumptions behind their charters have changed beyond all recognition. None of the problems to which GSEs were considered solutions were permanent problems — and none warranted a perpetual charter.

The better choice, limited life-charter, has some notable historical examples.

The First Bank of the United States, America's first GSE, was chartered in 1791. It was given a twenty-year charter. Its subsequent history clearly shows the power of a limited-life charter to force reconsideration of a GSE. When the charter expired in 1811, Congress voted not to renew it, and the first American GSE simply closed down.

Congress created the next GSE, the Second Bank of the United States, in 1816. The charter lasted for twenty years, expiring in 1836.

The dispute over whether this charter should be renewed is known as the famous "Bank War" between Andrew Jackson and Nicholas Biddle, president of the bank. Congress passed an act to recharter the Bank in 1832. Jackson vetoed it, accompanying his veto with a message of striking intellectual clarity and rhetorical vigor, which stands as a timeless critique of GSEs. Jackson observed:

- The powers, privileges and favors bestowed in the original charter operate as a gratuity to the stockholders.

- If the government sell monopolies and exclusive privileges, then they should at least exact for them as much as they are worth in the open market.
- Admit that the bank ought to be perpetual, and as a consequence the present stockholders will be established as a privileged order, clothed both with great political power and enjoying immense pecuniary advantages from their connection with the government.

Jackson's veto stood. In 1836 the Second Bank of the United States ceased to exist as a GSE and became a private sector bank.

Jackson's principles were unfortunately forgotten, but the GSE reform legislation now being considered by Congress presents an opportunity to redress the mistake of perpetual charters. Congress should give Fannie Mae, Freddie Mac, and the Federal Home Loan Banks limited-life charters. Having re-established this essential principle, Congress should then extend it to all other existing GSEs, such as the Farm Credit Banks, and to any GSEs that may be created in the future.

In short, no GSE should ever have a permanent charter.

Government Housing Bank of Thailand wins all Best State Enterprise 2005 Awards

The Government Housing Bank of Thailand (GHB), an IUHF member, has become the first Thai state enterprise to receive all three Best State Enterprise awards in a single year. In a recent special ceremony, Prime Minister Thaksin Shinawatra awarded three Best State Enterprise Awards 2005 to the GHB.

The State Enterprise Policy Office (SEPO) awarded GHB Best State Enterprise 2005 awards for Best Performance, Best Board of Directors and Best Management.

Khan Prachuabmoh, GHB's President said that he wished to thank everyone associated with the Bank for contributing to its unprecedented success. "We are most proud that GHB has been recognized as one of Thailand's most well-run State Enterprises," he said.

Fifty-three State Enterprises including PTT Exploration and Production Plc entered the competition. Each entrant's performance was measured by the Thai Rating and Service Company Ltd (TRIS).

The Government Housing Bank is now widely recognized as the "Hidden Gem" of the Thai Banking industry. Established in 1953, the Bank has 2,093 employees operating from 120 branches nationwide.

Prime Minister Thaksin Shinawatra presents Khan Prachuabmoh with one of the three awards won by GHB.

GHB has more than 900,000 mortgage loans outstanding and has a 38 per cent market share of the Thai mortgage market.

As of December 31, 2004, GHB had total assets of Bt448 billion ($US11.2 billion) and a net profit for the year ending December 31, 2004 of Bt4.811 billion ($US120 million). GHB is the top Thai bank when ranked by operating efficiency and its 2004 return on equity of 20.92 per cent was third among all Thai financial institutions.

Khan added that the annual Best State Enterprise Awards encourage State Enterprises to continuously enhance operational performance and at the same time improve the quality of Thai life.

"All of our employees are proud to be part of an organization that has a mission to help every Thai person achieve his or her dream home," he said.

How to assess a well working mortgage market. Attempts of the European Commission to evaluate the cost and benefits of an integrated EU mortgage market

By Christian König, Head of Office, European Federation of Building Societies,[1] Brussels

In order to evaluate the cost and benefits of any legislative act the European Commission bound itself to the principle of better regulation.[2] This principle comprises the economic analysis of any legal actions before they are officially initiated. Since the area of mortgage credit legislation came to the attention of the European Commission, the benefits of any further action by the European lawmaker for now 25 Member States has been assessed by the British consultants London Economics. Following a public tender procedure the European Commission commissioned London Economics (who already assessed the benefits of the integration of the EU retail financial services positively for the European Commission in 2002[3]), again to study the costs and benefits of new initiatives that would lead to a fully integrated market for residential mortgage and home loans. This study, which was published in August 2005, could serve the European Commission in the future law making process as a justification for legal measure within the EU mortgage market.

This cost benefit analysis came to the conclusion that the deletion of existing obstacles within the different Member States would lead to concrete benefits for the overall economy in the European Union. The study

estimates the current (2005) value to the EU economy of such increased integration over the next ten years at Euro 94.6bn, which amounts up to 0.89% of the current EU GDP. The study estimates that by 2015 the integration of the EU mortgage credit market would raise the EU GDP by 0.7%. Furthermore, higher product availability would increase private consumption by 0.5% and therefore benefit consumers.

In assessing the benefit of an integrated market the consultants took the liberalisation of the British market as their example for a perfectly integrated European market. As a second step, the situation of the British home loan market was compared with the mortgage

[1] www.efbs.org

[2] see Communication of the European Commission on impact assessment dated 5.06.2002 (COM(2002) 276 fin) and Communication of the European Commission Action plan "Simplifying and improving the regulatory environment" dated 5.6.2002 COM(2002) 278 final

[3] London Economics (2002), "Quantification of the macro-economic impact of integration of EU financial markets", Report to the European Commission.

credit markets of EU Member States in continental Europe. The consultants concluded that most of the mortgage markets of the EU Member States did not work satisfactorily in comparison with the British market in which it seems that more than 4,000 (!) different mortgage credit products exist. The products availability in every Member State is one of the criterions which London Economics used to compare the markets and its development.

By comparing the markets the consultants also mentioned that mortgage credit with a LTV over 100 % were more common in the United Kingdom than in any other EU Member State. The possibility of financing privately owned residential estates with a credit which even covers extra costs such as registration, notary fees and taxes gives almost everyone the chance to acquire residential property despite his or her financial capacity. The consultants then regretted that hundred percent finance are quite uncommon in continental Europe. This is due to reasonable economical causes. In many EU Member States a mandatory amount of saved own capital is required in order to take out a mortgage credit. This guarantees that consumers are not overwhelmed by their financial obligations during the repayment period of the credit.

These requirements have several benefits. Firstly, they guarantee that the risk of over-indebtedness of consumers is quite limited. Secondly, it therefore also assures that the residential property loan is fully paid back at the age of retirement. A debtless residential property is valued in many EU Member States as an equity which ensures greater independence from social security systems. The necessity of own capital requirements and pre-savings is seen in continental Europe as the principle of responsible lending. The consultants of London Economics brought forward in their analysis that this kind of product (credit with LTV over 100 %) would also enrich European product variety. Moreover, a certain number of people, who are right now excluded due to their financial capability, would certainly benefit from these financial products. This could open up a new business field.

In this context, it seems surprising that the Bank of England raised its concerns of over-indebtedness of British consumers this summer as well. The Bank of England worried in its second quarterly inflation report this year that the average British household has debts equivalent to 140 % of its income. The average saving ratio of British consumers dropped to the lowest level of 4.6 % in the last 40 years. Comparing the average German savings ratio of currently 10 % one could have certain doubts if the currently available financial products within the UK are clearly favourable compared to the ones offered in continental Europe. But again, the British market has been taken as an example for a perfectly integrated European mortgage market.

Additionally, the authors of the study consider the differing ownership structure of credit institute as obstacles to a European internal market. It is not possible to take over institutes subject to public law. As a consequence, the banking market cannot yet consolidate itself sufficiently according to the authors of the study.

It is also not acceptable that London Economics repudiate explicitly the saving for housing scheme in some European countries as an obstacle for the secondary mortgage market development. The advantages and benefits of these systems to the overall economic stability are not mentioned in this study at all.

With regard to gaining growth potential for the EU in the mortgage credit sector, the authors lay out a proposal for a better consumption of a property's value. According to this, it should be possible to take out loans for consumption purposes and to use the self owned property as security for those loans.

In so doing consumption would be stimulated since consumers would be able to use the capital invested in the property as collateral for future loans. Again, this proposal does not take into account that rent-free living contributes substantially to guarantee social wealth at retirement age in most of continental Europe's countries. Besides, by granting this kind of loans, consumption would be stimulated only for a short term, since the loan has to be paid back after all.

Many of the Anglo Saxon considerations on which this cost benefit analysis is based ignore that in continental Europe a different financing culture developed. Europe is much more diverse and it does not match in principle with the ideas from Great Britain.

Overall London Economics also explained which policy measures are necessary in order to achieve an integrated market for mortgage credit within the European Union. Unlike the former attempts of the European Commission to establish a common market by harmonising contract law rules of all European Union Member States on a certain high level, the consultants propose the approach of mutual recognition of financial products. This approach would have ideally the advantage that products from every

Member State could be offered cross border to a consumer in another Member State, without changing the features of the mortgage credit loan in accordance with the law of the consumer. London Economics supports the idea of mutual recognition of financial products since this would enable the consumer to benefit from offers of other EU Member States. Therefore no harmonisation measures are necessary by the European legislator. This approach is clearly in the sense of a free internal market. In order to compare products offered from other Member States, consumers need of course to be informed in order to be capable to compare the different features of products offered from another Member State. Therefore the consultants propose to enhance pre-contractual information requirements on the European level. The European credit industry acknowledged already the needs of pre-contractual information within the internal market of the EU and elaborated the European Code of Conduct on pre-contractual information for home loans which has been signed in 2001 and is currently implemented in around 19 EU Member States and some neighbouring countries. The approach of mutual recognition of financial products is certainly supportable since only by this principle consumers would get the true promise of an internal market if the variety of existing financial products in each EU Member State could be offered cross border.

Hopefully the European Institutions will realise in its further considerations concerning the regulation of home loans and mortgage credit that a Europe of 25 Member States is in reality much more differentiated then some consultants think in theory.

Capital Adequacy Regulation in India

By Renu Karnad, Executive Director – Housing Development Finance Corporation Limited - India

Renu Karnad

Backdrop of the Indian Financial Sector

The Indian financial sector is characterised by the diversity of its composition. There are 289 commercial banks categorised as public, private and foreign banks. The public sector banks dominate the main share of the banking system while some of the new private sector banks are benchmarked to world-class banks. Urban co-operative banks (UCBs) cater to small borrowers in urban and semi-urban areas. There are 1,872 UCBs. The traditional providers of long-term finance, Development Finance Institutions (DFIs), function as specialised or refinance institutions. The non-banking financial companies (NBFCs) are niche players, in the areas of equipment leasing, hire purchase or investments. There are currently 13,187 NBFCs. All these entities fall under the regulatory ambit of the Reserve Bank of India (RBI), the central bank of the country.

Given the acute shortage of housing in India and the lack of credit to housing, an apex institution, the National Housing Bank (NHB) was established in 1988. NHB is a

Aggregate Capital Adequacy Ratios (CAR)

	Commercial Banks	UCBs (Scheduled)	DFIs	NBFCs	HFCs
Minimum CAR	9%	9%	9%	12-15%[1]	12%
CAR as of Fiscal 2005	12.9%	11.0%	22%	26.8%	NA

[1] Depending on nature of business

Source: RBI, Annual Report, 2004-05

100% subsidiary of the RBI and is the regulatory body of Housing Finance Companies (HFCs). There are 30 HFCs approved for refinance, of which only 10 have assets in excess of INR 100 million (USD 2.2 million). Housing Development Finance Corporation (HDFC) is the largest HFC.

The Retail Thrust

Towards the end of the 1990s, against the backdrop of lower interest rates, industrial slow-down, sluggish credit off-take and ample liquidity, commercial banks recognised that if they had to maintain their profit margins, they needed to shift their focus from the wholesale segment and build their retail portfolios. Lower interest rates, rising disposable incomes and fiscal incentives made housing finance an attractive business. Housing finance is characterised by low non-performing assets and given the vast demand, most banks began aggressively marketing housing loans. Increased competition benefited the customer but the frenetic activity in housing finance put the regulators on alert.

Regulatory Concerns

While the housing finance market has been growing consistently at over 30% in the last few years, the regulators have cautioned that there is no substitute for prudent lending.

Though the demand for housing is genuine, the rise in certain banks' exposure to real estate, especially land deals, does warrant monitoring. The RBI subsequently raised risk weights for banks on individual mortgages from 50 to 75% and on commercial real estate exposures from 100 to 125 %.

NHB also increased the risk weight on individual mortgages to 75% for HFCs. It may have been more prudent if the authorities had increased the risk weight only for loans with high loan to value ratios (above 75%), rather than stipulating a blanket increase. This is contrary to Basel II, which has decreased the risk weight on individual mortgages.

Roadmap to Basel II

The roadmap to Basel II has been drawn up only for commercial banks, but it is only a matter of time before it is extended to other financial intermediaries. Commercial banks are to be Basel II compliant by March 31, 2007. Banks will initially adopt the Standardised approach for credit risk and the Basic Indicator Approach for operational risk. Selected banks may be allowed to migrate to the Internal Rating Based approach subsequently.

The RBI has adopted a consultative and participative approach towards adoption of Basel II norms. Risk based bank supervision has been introduced in 23 banks on a pilot basis and banks have been directed to formalise their capital adequacy assessment process in alignment with their business plans and budgeting systems.

Concerns and Issues

While the authorities are confident of a smooth transition to Basel II, there are some challenges and concerns in the Indian context.

First, estimates indicate that implementation of Basel II for banks may shave off about 2 to 2.5% from their current levels of CAR, mainly on account of operational risk. The banking system would require additional capital of INR 180–200 billion (approx. USD 4.4 billion) over the medium term to meet the norms. Besides raising equity, new instruments like preference shares, hybrid Tier II and Tier III capital may need to be explored.

Secondly, the extent of rating penetration in India is very low. Currently ratings are issue and not issuer based. Since Basel II recommends that an entity rated BBB or below carries a risk weight of 150% as against a 100% of an un-rated entity, encouraging fresh ratings may be challenging.

Thirdly, improving information systems may be challenging for some financial entities. Heavy expenses may need to be incurred on strengthening the IT architecture and improving information and reporting systems.

Lastly, the vast number of financial entities in India will pose difficulties for the regulators from a supervisory perspective.

Impact of Basel II on HFCs

HFCs also need to gear themselves towards implementation of Basel II. There is, however, a need for harmonization between regulators. For instance, the minimum CAR for banks is 9% as against 12% for HFCs. Further, it is unlikely that the regulators will permit a 35% risk weight on individual mortgages as stipulated in Basel II, despite low non-performing loans and foreclosure norms being in place.

Of greater concern is whether the smaller HFCs will be able to raise additional capital to meet Basel II norms. HFCs are increasingly finding it difficult to raise resources at competitive rates. HDFC may stand as exception. HDFC recently concluded an equity-oriented foreign currency convertible bond (FCCB) of USD 500 million. This has been the largest such offering in Asia (ex-Japan) in fiscal 2005 and has helped HDFC shore up its CAR. But from an overall industry perspective, HFCs are at a disadvantage vis-à-vis banks as they do not have access to savings and current accounts which are relatively cheaper sources of funding.

Moving forward, the smaller HFCs may need to re-orient their role as originators of loans. Though the securitisation market in India is still in its infancy, the government has recently committed to introducing a bill in Parliament which will enable securitised instruments to be listed, thereby increasing liquidity and trading.

To conclude, the regulators have a daunting twin task – ensuring that the Indian financial system migrates to Basel II in a non-disruptive manner and to encourage the housing finance sector to continue to grow prudently, with the ultimate aim of alleviating the acute shortage of housing in the country.

Basel becomes law in Europe

By Simon Walley, Deputy Secretary General, European Mortgage Federation

Simon Walley

The European Parliament turned the Basel framework into European law on 28 September 2005, the first jurisdiction in the world to do so. The Capital Requirements Directive, as the law is known, will govern the amount of capital credit institutions will have to hold against unexpected losses. Now that the law is in place, the countdown has well and truly started for banks and the regulators who supervise them. The Standardised Approach (SA) becomes available in a little over a year and the more advanced Internal Ratings Based (IRB) approaches will be adopted from the beginning of 2008.

The Directive will have major repercussions for Europe's financial system in the way risk is assessed and how much banks will have to put aside to guard against these risks. One of the main themes of the new rules is to make capital more risk sensitive, which means making better and more accurate judgements about the risks which are faced by institutions. The old 'one size fits all' risk buckets have been updated and a range of options are available to banks now depending on their size and the complexity of their business.

Vive la difference

The European version of Basel differs from the global framework in a number of ways which aim to reflect Europe's specificities.

- **Wider Application** – Unlike most other countries the new law will apply to all credit institutions and investment firms in the European Union which includes banks and non-banks. The insurance sector will also soon be subject to similar regulations under the so-called Solvency II Directive which is currently under discussion

- **Partial Use** – This allows banking groups who may have operations spread out across several countries to use the standardised model for some parts of their portfolio or some subsidiaries whilst using a model approach in other parts.

- **Covered Bond treatment** – Covered Bonds are a funding instrument particular to Europe, but gaining in popularity as a cheap and efficient way of raising liabilities. The securitisation treatment available under Basel did not fully reflect the low risk nature of this instrument which unlike RMBS remains on the lender's balance sheet. A special favourable treatment has therefore been developed to better reflects the risk of this instrument with a lower risk weighting under the standardised approach and a lower Loss Given Default figure under the Foundation IRB approach, as well as rules governing the assets which are eligible to be used in the 'cover' pool.

Onwards to implementation

The ball is now very much in the court of national regulators and banks to ensure that they are ready to meet the 2007 and 2008 implementation dates. The picture across Europe is mixed with some jurisdictions seemingly very behind whereas others had been quite disappointed that the original 2006 implementation date had slipped. The challenge at the European level will be to get some consistency in the way the Directive is implemented. The Committee of European Banking Supervisors (CEBS) has a key role to play in this respect both as a provider of information and as a forum to reach compromise on issues where a European level playing field is important.

Still some concerns

Chief amongst the remaining concerns is non-implementation in the US. Shortly after European approval of the Directive the US authorities announced that they would delay implementation until 2009. It is likely that in any case implementation would be limited to a handful of banks with other institutions going on Basel IA which effectively just modernises some aspects of the old accord. Basel was designed as a global regulatory framework and non-implementation in the world's largest financial services market could have important competitive repercussions.

Alongside this, and despite the various Quantitative Impact Studies (QIS), the dynamic effects of hundreds of Advanced IRB models running together is uncertain. Regulators will have some room for manoeuvre through scaling factors in the initial years of implementation which allow the new rules to be phased in. Pillar two also provides an additional security from the regulatory point of view, but nevertheless there will still be an element of 'wait and see' once the new systems go online.

Lastly the effect on competition remains uncertain. The European Commission's mantra has been 'Same Activity, Same Risk, Same Rules'. However in practice, there will inevitably be winners and losers, the concern is that smaller institutions without the resources to implement the advanced approaches will be penalised as their larger competitors benefit from substantial reductions in their capital requirements, which will allow them to price more keenly or use the extra capital to further expand their business.

Conclusions

The new risk based system is clearly a step forward on many fronts and aligns regulatory capital with the economic capital which banks have being using internally for a number of years to manage their risks. The mortgage sector is likely to benefit under the new rules which in our view is simply a reflection of the low risk nature of lending secured by real estate collateral. However a crucial step remains which is the implementation of the new rules. There are more than a hundred areas where national regulators in Europe have authority to decide how to apply the Directive. It is essential on the one hand to have flexibility to reflect national characteristics, but the competitiveness of Europe's financial markets would not benefit from having 25 distinct regulatory regimes.

European mortgage markets continue to boom in 2004

In the latest release of its annual publication on mortgage markets, *Hypostat*, the European Mortgage Federation confirms the remarkable progress of Europe's housing and mortgage markets over the past few years. Annik Lambert, Secretary General Designate of the European Mortgage Federation commented:

"The prolonged upsurge in mortgage lending throughout Europe continues to show the importance of mortgage credit as a means to achieving home ownership. Especially in the EU's new member States borrowers are discovering the benefits that secured lending can bring in terms of lower rates, longer maturities and the ability to release capital from their homes."

The key points of the new publication are:

- Mortgage loans outstanding at the end of 2004 amount to €4.7 trillion for the EU 25.
- This constitutes 45% of the EU's GDP or the equivalent of approx. €10 000 for every citizen of the EU.

Table 1 - Overview of European residential Mortgage Market, 2004

	Value of mortgage debt € million	Growth in mortgage debt	Residential Debt to GDP Ratio	Per capita mortgage debt, €
Belgium	88,434	8.2%	31.2%	8,506
Czech Republic	6,576	34.9%	7.6%	644
Denmark	174,300	6.0%	89.7%	32,292
Germany	1,157,026	0.1%	52.4%	14,019
Estonia	1,500	57.3%	16.6%	1,110
Greece	34,052	28.3%	20.6%	3,084
Spain	384,631	22.9%	45.9%	9,083
France	432,300	12.2%	26.2%	7,217
Ireland	77,029	29.8%	52.7%	19,125
Italy	196,504	13.4%	14.5%	3,395
Cyprus	2,182	4.6%	17.6%	2,988
Latvia	1,273	67.5%	11.5%	549
Lithuania	1,258	88.3%	7.0%	365
Luxembourg	8,797	12.3%	34.3%	19,480
Hungary	7,767	35.1%	9.6%	768
Malta	1,236	20.6%	28.6%	3,090
Netherlands	518,115	14.3%	111.1%	31,868
Austria	48,064	20.9%	20.3%	5,905
Poland	10,686	22.9%	5.5%	280
Portugal	70,834	6.9%	52.5%	6,762
Slovenia	387	30.3%	1.5%	194
Slovakia	2,032	82.3%	6.1%	380
Finland	56,522	10.8%	37.8%	10,829
Sweden	147,163	10.0%	52.7%	16,396
UK	1,243,261	11.1%	72.5%	20,835
EU15	4,566,198	9.6%	46.4%	11,931
EU 25	4,670,736	9.7%	45.3%	10,223
US	7,568,200	13.8%	64.5%	25,772

- Net lending in 2004 amounted to €412 billion which represents around 4% of the EU's GDP.
- In a recovering EU economy, where GDP grew by 2.3%, the EU mortgage market grew by 9.7% which is above the increase of 7.4% last year and of the average rate of 8.5% over the last 5 years.
- The UK has overtaken Germany to become Europe's largest mortgage market, with €1.2 trillion of loans outstanding or almost a quarter of all EU mortgage balances.
- The smallest national mortgage market in the EU 25 is in Slovenia. At the end of 2004 mortgage lending outstanding was €387 million.
- House prices grew particularly strongly during 2004 in Malta (18.8%), France (17.6%) and Spain (17.5%). Belgium, Denmark, Ireland and the UK also experienced significant house price growth of around 11%.
- Conversely Germany and Austria have seen negative house price growth.
- According to the EMF data which looks at interest rates on new mortgage lending in the EU, interest rates have halved in most EU countries between 1994 and 2004.
- The Swiss have the lowest level of home ownership in Europe at 35 % compared to the highest which is in 98% in Lithuania. However, they have a very high level of mortgage dent to GDP (86%) and the highest level of mortgage debt per capita among the countries analysed in this report.
- In the EU 25 the number of dwellings per 1000 inhabitants is 434, in the EU 15 it is 457

and in the new central and eastern European member States it is 399. Spain followed by Austria and Greece has the highest number of dwellings per 1000 inhabitants while Poland and Slovenia have the lowest number of dwellings per 1000 inhabitants.

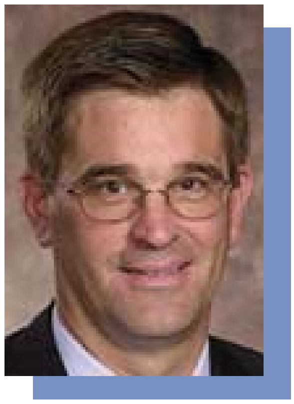
- Retail deposits are still the main funding source in the EU. However, housing loans as a percentage of deposits by households in the Euro zone grew from 43% in 1997 to 64% in 2004. Other funding sources such as MBS or covered bonds are therefore growing in importance.

Hypostat can be ordered from the European Mortgage Federation via its website (**www.hypo.org**) or by contacting **emfinfo@hypo.org**

Housing activities should decline modestly next year

By Orawin Velz – Director of Economic Forecasting, Mortgage Bankers Association, and Doug Duncan – Senior Vice-President and Chief Economist, Mortgage Bankers Association

Doug Duncan



Outlook for Economic Growth

The US economy has shown remarkable resilience in the face of recent hurricanes and the associated energy-price spike. The economy had strong momentum pre-Katrina, and it remains on track for solid growth in the current quarter, albeit slower than in the third quarter. Recent data suggest, however, that the slowdown caused by hurricane-related disruption will be short-lived. Growth should pick up strongly in the first half of next year, boosted by rebuilding efforts, which should gain momentum in early 2006. Although gasoline prices have receded significantly from their high immediately after the hurricanes, high natural gas prices present a risk for the economy going forward.

Unusually strong home price appreciation of the past several years has allowed homeowners to extract a significant amount of home equity, boosting consumption spending. Because many consumers are already highly-leveraged, continued increases in interest rates should put additional constraints on their spending. In addition, consumers will likely face extremely high bills for home heating fuels this winter, reducing their disposable income. Home price appreciation is also expected to moderate going forward, further dampening consumer spending growth.

Economic growth should slow in the second half of next year when expenditures for rebuilding in the storm-damaged regions wane (see Figure 1). Growth will continue to be solid, however, as growth in business investment should pick up to offset slowing consumption growth.

The Labor Markets Will Remain Solid

Although employment gains were disappointing in October, the labor market remains fairly healthy. The softness in employment is likely to be temporary rather than the start of a deteriorating trend. Indicators of softening labor markets, such as initial unemployment claims, have now reverted to the trend levels prior to the hurricanes. Other economic indicators – including expanding manufacturing activity, low inventories and receding energy prices – point to a strong labor market going forward.

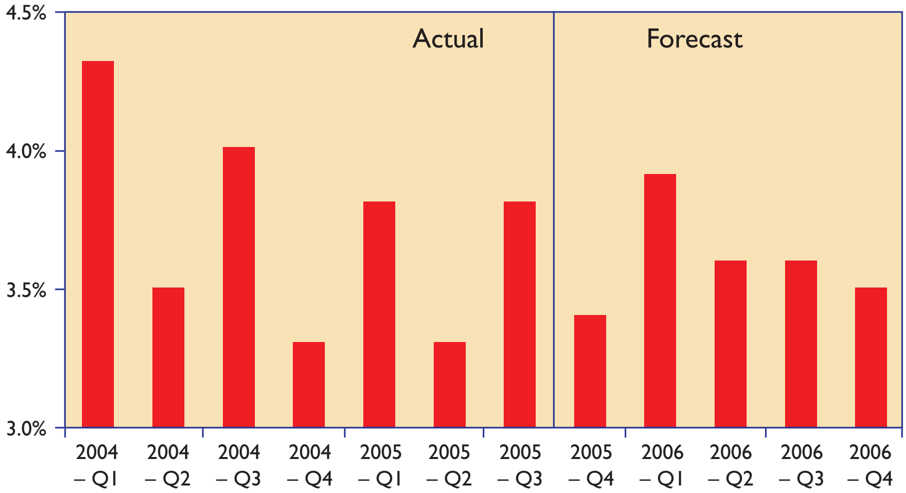
The Fed Will Continue Its Modest Tightening

Following the hurricanes, inflationary pressures have become more of a concern. Core inflation is now at the upper end of the Fed's comfort zone consistent with price stability. We expect that the Fed will continue to be vigilant on inflation, pushing up the federal funds rate during each of the next three FOMC meetings to 4.75 percent. Then it will stay on the sidelines and wait to assess the cumulative impact of the previous rate increases.

The Housing Market Will Cool Modestly

The housing market appears to have peaked, according to several leading indicators of housing

Figure 1 – Real Gross Domestic Product



Source: Bureau of Economic Analysis

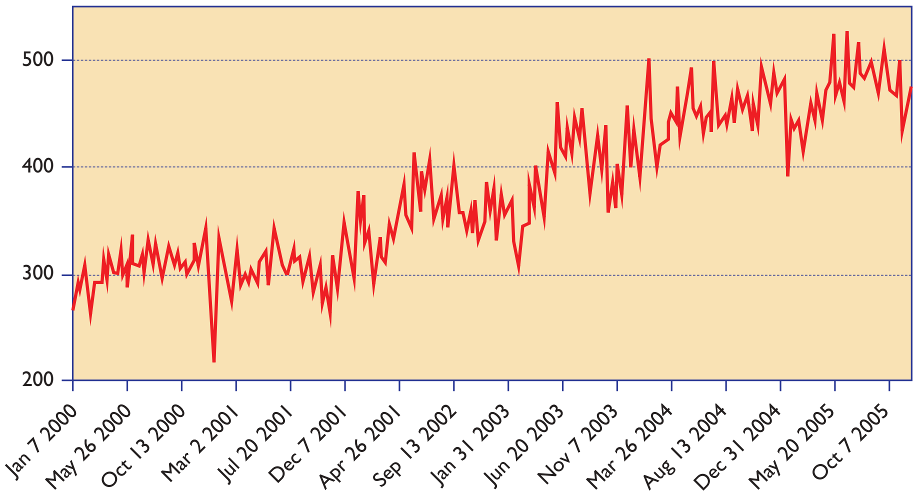
activity. In particular, mortgage applications for home purchases have trended down and housing inventories have continued to increase. The Mortgage Bankers Association purchase application index declined by nearly five percent in October from September to the lowest reading since March. Although the purchase index increased again in early November, reversing an extended downtrend, the index remained nearly seven percent below its most recent high in early September and is below the level of November 2004 (see Figure 2). However, the level of purchase applications is still strong historically, suggesting that the decline in home sales in the coming months should be modest. Combined with the very strong pace of year-to-date home sales, both new and existing home sales should set a fifth consecutive record this year. With projected modest increases in mortgage rates through next year, home sales should decrease by about 3.5 percent in 2006.

Leading indicators for home building activity suggest that home building will likely trend down moderately in the coming months. After holding up better than expected in the previous two months following Hurricane Katrina, home builders' optimism dropped sharply in November to the lowest level since May 2003. A sharp uptick in mortgage rates over the past two months and rising building material costs are likely responsible for the decline in optimism. We expect residential construction to decline modestly by about 5 percent in 2006, as reconstruction efforts should help support homebuilding activities in the affected Gulf region.

Housing inventories continue to build for both new and existing homes, with the months supply (inventory/sales ratio) rising significantly over the past year (see Figure 3). Condo inventories have accumulated much more than single-family homes, rising by 36.6 percent in September

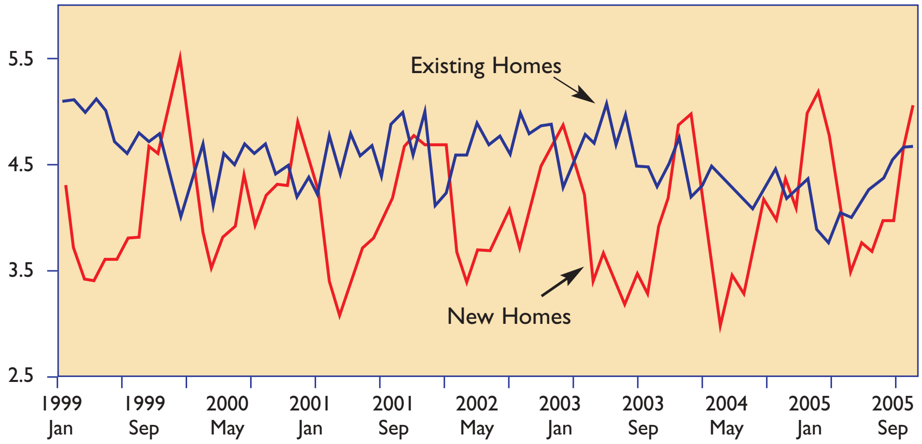
Figure 2 – Purchase Application Index

Index: March 16 1990 = 100



Source: Mortgage Bankers Association

Figure 3 – Months Supply (Inventory/Sales Ratio) of New and Existing Homes



Source: Bureau of the Census and the National Association of Realtors

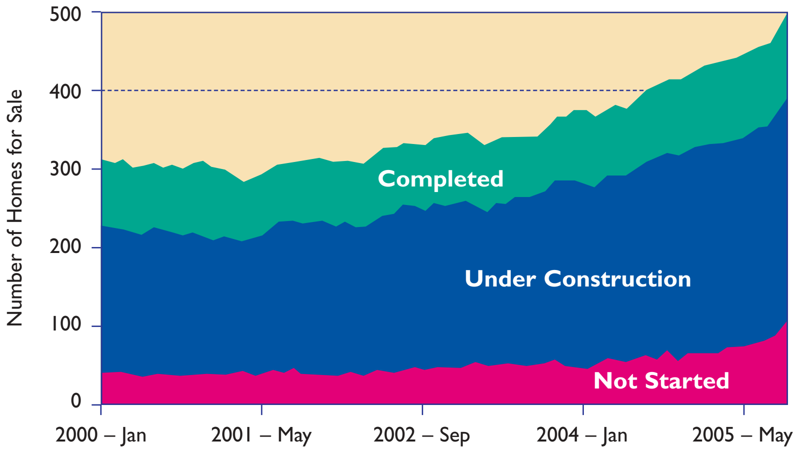
from a year ago, with the months supply increasing to 5.3 from 4.3 a year ago. These inventories pose a downside risk for the housing market if demand were to pull back sharply. The current situation is not alarming for new homes, however, as the structure of inventory is still healthy. Nearly 22 percent of new homes for sale in September are units that have permits but have not yet been started – a record-high share (see Figure 4). This could be either because banks are more reluctant to finance spec construction or because builders have exercised caution. Regardless, this implies that builders could pull out a large portion of the increase in inventory if demand were to soften.

With the projected modest decline in home sales in 2006, home price gains are projected to moderate next year from the very rapid and likely unsustainable pace of the past several years. With Katrina expected to put upward pressure on construction material costs, home price gains should remain healthy at about 5-6 percent next year – slightly less than half the pace experienced so far this year.

The ARM Boom Is Ending

Over the past several years, many analysts have been surprised at the persistently elevated adjustable rate mortgage (ARM) share of mortgage originations, given the historically low level of long-term fixed mortgage rates. Borrowers have traditionally gravitated to ARM products to extend their purchasing power in high cost markets. As the Fed continues to raise short-term interest rates, the yield curve has flattened significantly. ARM products are much more influenced by Federal Reserve policy than fixed-rate mortgage products. Since the beginning of the year, the spread between fixed and adjustable rate mortgage yields declined by over 40 basis points to about 125 basis points by mid-November. The share of adjustable rate mortgages for conventional purchase loans has slowly trended

Figure 4 – New Homes Available for Sale



Source: Bureau of the Census and the National Association of Realtors down since last June, when the Fed started monetary tightening. Continued steady rate hikes expected over the coming months and subsequent increases in ARM rates would further deteriorate housing affordability conditions, cooling ARM lending.

Refinancing Fades

Mortgage rates have come off their lows and refinancing activity is now fading. The MBA refi index continues to slump from its recent peak in early June. As mortgage rates are projected to continue to rise through next year, refinancing activity, as well as the subsequent lift to spending, is expected to dwindle in the second half of the year and into 2006. The cash-out refi share should rise as mortgage rates continue to increase, as more homeowners choose to refinance to liquefy equity rather to reduce monthly mortgage payments. Cash-out refis are more attractive than home equity loans and lines of credit during an environment of rising short-term interest rates. Going forward, we expect a lower level of home equity borrowing, as higher interest rates continue to dampen demand for mortgage refinancing and home equity loans and lines of credit.

U.S. Mortgage Finance Assets and Yield Spread

Global investor demand for mortgage-backed securities (MBS) has surged in recent years, as investors "reached for yield" seeking higher returns than those available on government bonds. Investors can purchase a variety of mortgage assets with differing structures of risk and return over a given period of time, from agency MBS to subprime mortgage securities.

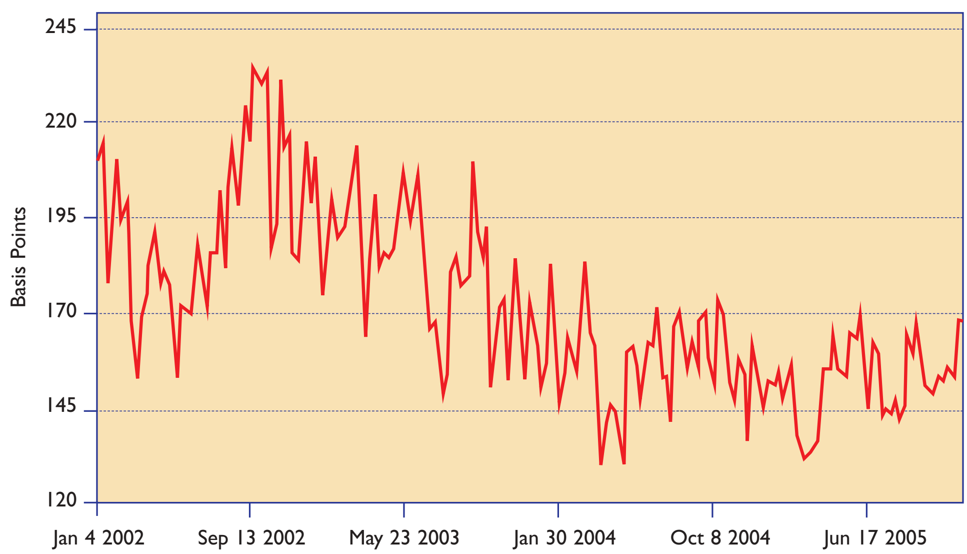
Mortgage assets must compete with other fixed-income assets, such as U.S. Treasuries, which are devoid of default risk. Mortgage assets carry more risk of default and early repayment and thus mortgage rates must be priced higher to compensate for the risk. The spread between mortgage rates and the yield on 10-year Treasuries varies with market conditions, investor demand and the supply of available product – as well as the returns on alternative investments, such as corporate bonds or stocks.

During a refi boom, the spread between mortgage and 10-year Treasury yields generally widens because prepayment risk increases. The spread has averaged about 150 basis points this year but has widened recently (see Figure 5).

Credit Quality and the Expected Modest Rise in Delinquencies Ahead.

Continued job gains and rising wages should be positive for household balance sheets. If interest rates rise gradually and housing activity declines modestly as we expect, credit quality should remain solid. However, many factors appear to be conspiring to increase delinquency rates in the near term. First, the large cohort of loans originated in the 2002-2003 refi wave is reaching the peak delinquency period. Second, rising short-term rates are putting pressure on ARM borrowers. Third, the share of subprime market has been growing significantly in the past several years. Finally, energy prices (especially natural gas and home heating oil) are expected to remain elevated going into the winter. Thus, it is reasonable to expect somewhat higher delinquency rates over the next several quarters. In general, however, consumer credit quality should remain healthy next year.

Figure 5 – Yield Spread: 30-Year Fixed Mortgages and 10-Year Treasuries

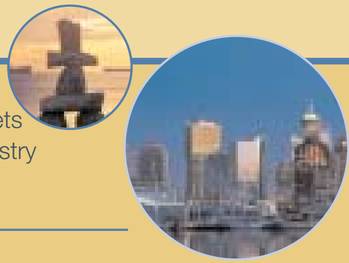


Source: Federal Reserve Board

3 Savile Row, London W1S 3PB United Kingdom
Tel: +44 (0)20 7494 2995 Fax: +44 (0)20 7734 6826
e-mail: information@housingfinance.org

Hosted by Canada Mortgage and Housing Corporation (CMHC), the 26th World Congress of the International Union for Housing Finance (IUHF) will take place for the first time ever in Canada - September 2006.

The Congress will bring to Vancouver hundreds of decision-makers in the field of mortgage finance from around the world. Delegates will include top level officials from housing finance and mortgage banking institutions, the public sector, and international financial institutions (IFI's).



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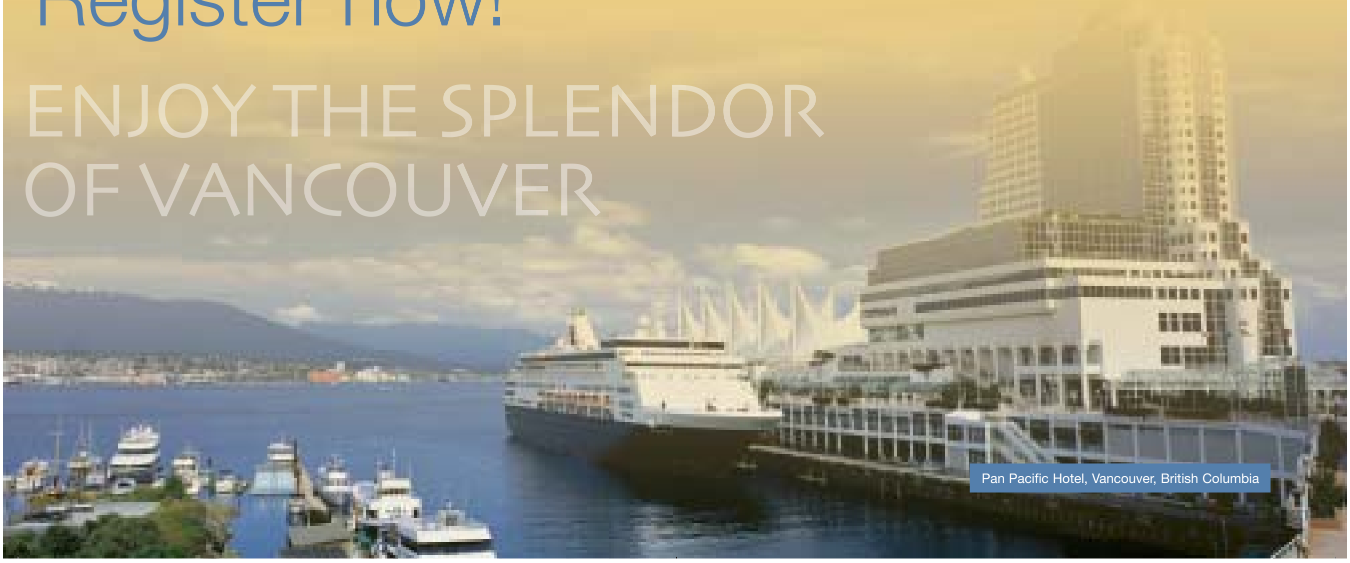

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