Housing Finance & Financial Deregulation: Issues in Developed and Developing Countries

by Mark Boléat

INTRODUCTION

Unlike most other financial services housing finance is predominantly a national business. Loans for the purchase of housing are generally secured on land, which by definition is fixed, and the legal systems governing the transfer of land differ considerably from country to country. Largely for this reason there has been, at least until recently, a comparative lack of information on what was happening in housing finance around the world. The main exception to this rule has been in respect of developing countries where the international aid agencies, in particular the *World Bank* the *United States Agency for International Development* and the *United Nations Centre for Human Settlements,* have promoted an understanding of problems and policy issues within a broad framework of development policy. Also, those seeking to establish housing finance systems in developing countries have not had the luxury of taking over an existing system which was working well, and have therefore deliberately had to seek to learn the lessons of other countries.

This text is published from an address given by MARK BOLEAT in Bombay in March of this year. At the time, Mr. Boleat was Director-General of the Council of Mortgage Lenders. He is now Director-General of the Association of British Insurers.

More significantly over the past few years there has been a substantial increase in interest in housing finance among developed countries. Democratisation of the countries of Eastern and Central Europe has been a catalyst for this. Those countries have been seeking to transform themselves from command economies into market economies and have naturally looked at banking in general and housing finance in particular in Western Europe and further afield. Among advanced industrialised countries the trends towards the internationalisation of financial markets, the imposition of common standards for capital adequacy and the spread of securitisation as a concept have led to greater interest in housing finance. Most recently serious problems with housing finance systems, particularly in America but to a lesser extent in some West European countries, have again led policy makers and academics to seek international comparisons so that mistakes can be learned from and successes emulated.

This paper briefly sets out the basic principles for the operation of housing finance systems, discusses the inter-relationship between housing finance and the economy as a whole, and then goes on to consider current problems in developing and developed countries.

BASIC PRINCIPLES

Housing finance is basically a very simple service. That is, a loan is made to an individual to enable him to purchase a house to which he will have full ownership rights. Generally, the loan is secured on the house, meaning that if the terms of the loan repayment are not met the lender can take over ownership of the house. This is advantageous to the borrower because it means a much lower rate of interest than would otherwise be the case .

Unless these basic elements are in place then a fully efficient housing finance system cannot develop. This is a lesson which has been learnt the hard way in Eastern Europe, where perhaps too much attention has been given to banking structures and sources of finance and not enough to the security requirements.

An efficient housing finance system in any country requires a sound legal framework governing the ownership and transfer of property. If ownership is uncertain, whether it be in a squatter settlement in Colombia, or in the former German Democratic Republic, then a housing finance system simply cannot work effectively. However, having an effective system of land law is not in itself sufficient. The lender must also be able to enforce his security, that is, if the borrower does not keep up repayments on the loan to take possession of the property and to sell it with vacant possession. Some East European countries, and indeed some developing countries, have quite efficient land laws but no mechanism for the lender enforcing their security. In such cases there is a reduced incentive for borrowers to repay

their loans, which means that underwriting standards have to be that much tighter, and the mortgage rate that much higher to cover bad debts.

On top of these basic building blocks is the need for a sound financial structure. There have been all too many examples in developing countries, now sadly being copied in some of the East European countries, of too many banks being created with no proper system of regulation and supervision. Any financial institution, in particular one that takes deposits from the public, must have an adequate capital base and sound management. In turn this requires an efficient supervisory system, generally, although not necessarily, run by the central bank. The supervisors have to be equipped in both legislative and resource terms to intervene where banks are not properly managed and if necessary to close them down before they do great damage to the financial system as a whole.

It is obviously more difficult for developing countries to have a sound financial structure, simply because of the lack of financial resources. It is therefore perhaps all the more important that a sound financial structure is encouraged by not distorting the financial markets, for example, by giving preference to government institutions or government securities.

Finally, a housing finance system can work effectively only if there is relative economic stability. It is simply not possible to devise a housing finance system that can cope with inflation of 100, 200 or 1,000 percent a year. In such cases even the most soundly based of systems collapses and is replaced by shorter-term ad hoc financing, as has been seen in some South American countries. The need for economic stability of course goes much wider than housing finance, but this point does emphasize that policy makers cannot seek to devise housing finance systems in isolation of economic developments generally.

HOUSING FINANCE AND THE ECONOMY

There are some who view housing finance as being a subject all on its own, which can be studied in isolation and to which policy measures can be aimed regardless of the wider implications. Indeed, until 20 years ago even advanced industrialised countries, such as the United Kingdom, had housing finance systems that operated on what was called a "special circuit". The system attracted funds that were not, in practice, available to other institutions, and made loans on terms that could not, in practice, be offered by more general banking institutions. West Germany today still retains such a system, but it is questionable how long it will be able to continue.

There is now a recognition of the importance of housing finance in the financial structure of economies generally. In the case of developing countries, a housing finance system can be a means of mobilising savings that otherwise could not be mobilised, and of deepening the financial system. The simple fact is that people will save for housing when they would not save for any other purpose. In industrialised countries, a poor housing finance system will severely hinder the mobility of labour, while a system that has artificial privileges is capable of causing massive disruption through stimulating over-investment in housing and an excessive increase in house prices.

This, however, is an area where there are very marked differences between developing and developed countries. In developing countries, housing finance must be seen as part of the development of the financial structure and of the economy generally. Although there must be other priorities, housing finance should be allowed to compete on relatively equal terms with other forms of finance. Its unique attributes mean that housing finance can play an important part in widening and deepening the financial system. In indutrialised countries housing finance is such a major part of financial markets that it cannot be ignored by policy makers in the context of macroeconomic management and policy towards the financial system generally.

THE PROBLEMS IN DEVELOPING COUNTRIES

In developing countries, the vital need is to establish a sound framework in which housing finance systems can develop. It is not a question of the Government creating financial institutions, giving them money and directing them on how to conduct their business. Rather, if the right framework exists a housing finance system will evolve of its own accord, although there are actions which governments can take which can stimulate growth in the short-term.

The priority must be to develop a satisfactory legal and administrative system for the ownership and transfer of land, and legislation that can be enforced allowing lenders to take possession of properties in the event of the borrower defaulting on his loan. Those countries that start from this basic point will be developing structures that in the long-term should create efficient housing finance systems. In countries where these fundamental points are ignored, the establishment of a housing finance system will be that much more difficult.

There is almost certainly an important role for specialist institutions especially in developing economies. The government may well have an important role in helping to establish such institutions, including providing them with equity capital. Having done that, the government must allow them to operate effectively and not seek to use them as part of the public sector. The government may also operate a mortgage insurance scheme to help stimulate the market.

Specialised institutions are necessary because lending for house purchase in developing countries is difficult; it is something

which general banking institutions prefer to avoid. A specialist institution can take advantage of that specialisation to develop policies and procedures appropriate to the unique characteristics of lending for house purchase. Such institutions also have a major role in informing and influencing governments and other financial institutions such that other specialist institutions can be established and more general banking institutions can be encouraged to lend for house purchase. The *Housing Development Finance Corporation* in India stands out as an excellent example of the former as does the *Government Housing Bank* of Thailand of the latter.

Generally, the difficulties faced by specialist housing finance institutions in developing countries stem from government action or inaction. Going beyond the points already made about legislation and enforcement of the security, an institution lending for house purchase has to compete for financial resources and that competition is not always fair. Governments can seldom resist the temptation to believe that they know best, and should determine patterns of lending and interest rates. Interest rate controls are often imposed in the naive belief that the lower the interest rate the more poor people benefit. The reality, of course, is that the lower the interest rate, the less that housing finance institutions can do. Directed credit systems can take resources away from housing finance, or worse still, housing finance institutions can be required to lend to people to whom loans should not ordinarily be made or for which the security is not adequate.

These points are very basic and are familiar to those running housing finance institutions in developing countries, the leading academics in the field and to the international agencies. However, they do not seem familiar to governments, perhaps because ministers change all too frequently. There is still clearly an urgent need to ensure a high level of understanding among governments generally as to the conditions needed to create an efficient housing finance system and the benefits that can be derived from thriving housing finance institutions. It is a sad fact that after so many years of hard work by the international aid agencies and dedicated staff in some of the housing finance institutions, there are today still only a handful of successful such institutions in developing countries with a rather larger number that are surviving and making a small contribution. The priority should be to create the conditions which encourage as many as possible of those institutions to become like *HDFC* and the *Government Housing Bank* of Thailand.

THE EXPERIENCE OF DEVELOPED COUNTRIES

There are a range of different issues in developed countries. Some of them are not too dissimilar from the problems facing developing countries and a wide understanding of housing finance markets around the world is helpful for policy makers in any country. Housing finance is not an area that one can easily experiment with, and one should seek to learn whatever lessons are available elsewhere.

Housing finance systems in developed countries have evolved over a period of 100 or more years. If one was starting afresh one would probably not have the systems that exist today. However, one has to start from where one is and not from where one would like to be.

In most industrialised countries there have been, until recently, specialist institutions which have accounted for a significant share of lending for house purchase. In Britain, Ireland, Australia, South Africa and New Zealand these institutions have been *building societies.* In America, they were *savings and loans* institutions. In many continental European countries they were *mortgage banks,* raising funds on the wholesale markets unlike the building societies and savings and loans. These institutions have all had restricted powers, but generally they have also been protected from competition by favourable legislation, or by the absence of the controls that have applied to banks.

With a few exceptions most countries have had housing finance systems in which the large commercial banks played a relatively small part. This has not been because of any policy decision on their part, but, rather, has resulted from balance sheet controls implemented in the name of monetary policy. This goes back to basic economic theory which suggests that bank lending or bank deposits are money, and by inference deposits and lending by institutions which are not banks, even if they have all the characteristics of banks, are not money.

When housing finance was relatively small in relation to the finance system generally this strange situation was allowed to persist and did no damage. However, what happened in a number of countries was that the uncontrolled so-called specialist housing finance institutions grew substantially at the expense of banks, taking deposits and loan business away from them. As they grew so they began to have a greater influence on monetary variables and were capable of frustrating monetary policy. The absurdity of levying controls on banks which resulted simply in activity shifting to a different type of institution rather than that activity not taking place, was gradually appreciated.

The policy response was the fairly obvious one. The direct balance sheet controls on the banks were abolished (or in some cases extended to other institutions) with the government seeking to control the monetary aggregates by general policy measures, in particular interest rates. At the same time, the specialist housing finance institutions have been allowed to adopt a more wide-ranging function. In some countries, notably South Africa and America, the distinction between banks and the specialist mortgage lending institutions has, in effect, been abolished. In others, and this applies also in America but more particularly in Australia, the specialist building societies have converted themselves into banks.

This process of changing the method of implementing monetary policy and deregulating specialist institutions has been conducted with varying degrees of effectiveness. The country that got it mostly wrong was the United States. Initially the savings and loan associations were confined in effect to borrowing short-term and lending long-term. As interest rates rose so they came under immense financial pressure. Instead of addressing this problem directly, the government compounded the error by deregulating the institutions in the hope that they could make greater profits to compensate for the losses on their mainstream business, and propped up the mortgage market through massive government support through secondary market agencies. Instead of strengthening supervision it weakened it. The result was inevitable. Crooks were virtually invited into the business, billions of dollars were lost, and there has had to be massive support from the tax payer to make good government guarantees to depositors. Australia has also failed to set it right by deregulating the building societies too little and too late. As a result all of the large building societies have become banks. Britain has got it just about right. The deregulation was accompanied by much stricter supervision, which has enabled building societies to come through a very difficult market in a strong position. Only one building society, the second largest, the Abbey National, has converted to banking status.

THE PROBLEM OF FALLING HOUSE PRICES

Recently a new problem has emerged, that is falling house prices. Housing finance institutions have lent on the security of property, and there has been a general perception that property could not fall in value. This was true when inflation was running at a high level. Even if house prices fell relative to other prices they continued to increase in nominal terms, while the burden of loan repayments was progressively eroded through inflation.

Perhaps the most remarkable economic change over the last 10 years has been that inflation has been virtually squeezed out of the system in most industrialised countries. In Britain the inflation rate is now under 2%, the lowest level for over 30 years. Some are actively contemplating falling nominal prices. While generally lower inflation must be a good thing, it brings transitional problems certainly in respect of the housing market, and this has been well illustrated by the British experience.

The British housing market has traditionally shown marked cyclical fluctuations. As real incomes have risen so demand for house purchase has increased and as the available stock has been gradually eroded prices have tended to rise leading to expectations of further price increases which then became self-fulfilling. After the boom must come the inevitable slump, but until recently this simply meant that house prices stood still while inflation continued to run at a high level and, therefore, real prices were restored to a reasonable level.

The most recent cycle in Britain has not been quite like this. The boom in the 1980s, was a very long one running for six years. Just as the boom was about to peak the housing market was given further stimulus by tax measures. This has made the readjustment all the more painful. From 1989, interest rates began to rise sharply as did unemployment. Housing activities slowed down markedly, and the rate of increase of prices decelerated sharply. This happened at a time of falling inflation. Much to almost everyone's surprise over the last few years prices have fallen sharply in nominal terms. On national average, prices in Britain are now about 15% below their peak levels, but in the Southern parts of the country the fall has been 30%. In real terms, this means that house prices have now fallen in some parts of the country by over 40% since the end of 1988.

Britain is not alone in experiencing this phenomenon. It is, in fact, far worse in the Scandinavian countries. In the 1980s, the Netherlands and Belgium had a similar experience, and it would not be surprising to see the same pattern emerging in some other Western countries.

The fall in nominal house prices has had profound consequences for housing markets and housing finance institutions. In Britain, mortgage lenders have taken possession of 150,000 houses over the last two years, whereas ten years ago the number of possessions was so small that the figure was not even counted. Mortgage lenders have worked energetically to keep people in their homes through intensive arrears management and counselling. Government help has been forthcoming in that people who have no income are entitled to state benefit to meet their mortgage interest. This benefit is now paid directly to lenders. Previously it was paid to borrowers and was not always used for its intended purpose.

Mortgage lenders have had to make substantial bad debt provisions. In the case of building societies alone, these provisions amounted to £2 billion in 1992, as against just £2 million five years earlier. Fortunately, because of the sound system of prudential supervision, societies have been able to absorb these bad debt provisions, and the capital strength of the industry has continued to increase. There have, however, been some casualties, and five building societies, having incurred operating losses, sought mergers with larger partners. Other mortgage lenders, in particular subsidiaries of foreign banks, have decided to withdraw completely from the British mortgage market.

FUTURE TRENDS

The experience of the last few years was not forecast by any commentator, so it is with some trepidation that one attempts to say what might happen in the next five years or so . However, it does seem possible to identify some basic themes.

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DEREGULATION . . .

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Deregulation is blamed by some for the turmoil in financial markets in the past few years, but this is not the general view. Deregulation, when badly done, as in America, has been disastrous. When well done, as in Britain, it has facilitated a smooth transition from a market which had become inappropriate in a modern economy to one that will serve nations well in the 21st century. Deregulation is here to stay. Those who talk about regulation generally confuse regulation with supervision. It should be automatic that deregulation goes hand in hand with tougher capital requirements and a more intrusive supervisory system. In the case of British building societies this was done at the outset. In other countries the lesson is being learned the hard way.

The barriers between markets and institutions will increasingly erode. Specialist housing finance lenders are likely to go out of business one way or another. Some may change their form such that they become more general banking institutions regulated in the same way as other banks. Others, particularly those which are subsidiaries of banks, may be absorbed into the parent bank, and some will change their status into general banking institutions. Housing finance will be seen as one part of a wide range of retail financial services. Much of the business will be conducted by wide ranging banking institutions, but there will always be room for specialists, concentrating on housing finance and doing it efficiently.

In developing countries it is vital to continue to develop a sound institutional framework and to build on the experience of successful institutions. The market potential is huge. ■

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infrastructure services. However, the actual amount of land compensation reflects the economic value of acquired land.

[2] The model is based on a project with the following characteristics: site area of 50,000 square metres; a pre-redevelopment constructed area of 40,000 square metres (an FAR of 0.8); and 1,086 housing units within a total residential constructed area of 38,000 square metres (approximately 35 square metres per unit). It also contained 2,000 square metres of public facilities. The post-redevelopment simulation (baseline case) assumes that the site is redeveloped to an FAR of 2.0 and contains 100,000 square metres of constructed space. Reflecting practices in many cities, the simulation assumes that all households are resettled on site and that each household receives an average of 50 square metres of constructed area for a total area of 54,300 square metres. Additional public facilities are constructed to reach 5,000 square metres. After these allocations are made, there is an additional 40,700 square metres of commodity space. Total average construction costs (both hard and soft costs) are assumed to average Yuan 1,000 per square metre. ■