Government Intervention
and Regulation
Effects on Housing Finance

by Dr Horst Tomann

WHY GOVERNMENTS INTERVENE IN HOUSING MARKETS

The main objectives of housing policy are to provide affordable housing for a broad spectrum of people and to offer special assistance to discriminated groups. Hence, housing policy pursues predominantly social welfare objectives and is directed towards correcting the distribution of real income.

Traditionally, public housing, social housing subsidisation and rent regulation have been the instruments to pursue these ends. In recent years, housing policies have shifted more and more to granting means-tested housing allowances directly to private households.

A second factor which legitimises housing policy in a market economy is distortions in the housing market. Two different kinds of distortions may act together to form big and lasting market disequilibria. First, due to its long life-time, housing investment implies an extremely low turnover on capital. It is long-term expectations which command investment, hence investment does not visibly respond to demand shocks. Secondly, flexibility in adjusting the utilisation of existing housing stock to demand shocks may be restricted, which in turn aggravates the problem of market disequilibria. Therefore, housing policy is used to stimulate long-term expectations and to increase flexibility in the housing stock.

The instruments directed towards improving the performance of housing markets are urban land use planning, supply subsidisation (by grants or tax expenditure) and indirect measures which increase the flexibility of markets. Housing allowances also have an indirect effect.

Housing policies may also have detrimental effects on the markets' performance. In particular, market regulations in the existing housing stock may destabilise long-term expectations. It does not help to restrict market regulations to existing stock. A recent measure of German housing policy, for example, was to reduce the cap on rent increases for dwellings built prior to 1981. That measure signals to investors that the government may enact a similar change of regulations when their investments become profitable.

Furthermore, household mobility is restricted by the system of rent regulation. With regulated rents, excess demand in the rental housing market drives market rents up, but the rents in existing contracts hardly respond. Tenants have a disincentive to move, with the consequence of lasting market disequilibria and substantial price effects. Hence, as a consequence of inappropriate housing policies, house prices and rents may overshoot their long-term trends.

In view of lasting market disequilibria and overshooting, governments may have the objective to stabilise housing markets by direct intervention. In this respect, rent regulation is a case in point, too. Mortgage interest rates have been regulated for the same reason. Consequently, the demand for housing is rationed, either by government supervision or by the discretion of landlords and banks. Social housing programmes which provide extremely generous conditions for investors, as a rule, are also combined with rationing schemes, that in particular, imply incentives for rent seeking and corruption.

HOW TENURE DECISIONS ARE AFFECTED: THE CASE OF GERMANY

The impact on housing finance depends mainly on how government intervention and regulations affect tenure decisions. In Germany, for instance, a broad range of policies which significantly influence tenure decisions have to be considered. The main policies are:

- regulation of rental contracts;
- tax treatment of housing investment; and
- social housing programmes.

Regulation of rental contracts consist mainly of tenant's protection against notice

Dr HORST TOMANN is a Professor in the Department of Economics at the Freie Universität Berlin. This paper was presented at IUFH's 11th International School, Münster, in July 1994.
and regulation of rent increases for sitting tenants. Recent changes in regulation have strengthened tenants’ rights and have narrowed the limits for rent increases, with the consequence of increasing the opportunity cost of home ownership.

The tax treatment of housing investment presumably favours home ownership of high-income groups.

The German tax system entails three peculiar regulations providing specific incentives for housing investment:

- imputed income of home ownership is tax exempt;
- capital gains are tax exempt for private investors (although certain limitations apply);
- the government provides risk-sharing by passive-loss provisions which allow investors in rental projects to use losses from these projects to offset other income.

Hence, a combination of special depreciation allowances and tax-free capital gains exert a strong incentive to invest in private rented housing. High-income homeowners are treated on similar terms, however. They take advantage of the passive-loss provisions as well by deducting housing investment allowances and mortgage interest (with caps); moreover, special allowances for homeowners with children are granted. These provisions imply that home ownership subsidisation depends on marginal tax rates. Full-scale subsidisation starts with an annual income of approximately DM 80,000 and ends with DM 250,000.

Post-war social housing programmes have traditionally given priority to rented housing. There are programmes for owner-occupiers (during the late 1980s federal government assistance was restricted to these programmes), but they address upper middle class households. In general, social housing does not help low-income households to overcome access barriers to home ownership.

In total, increased regulation of rental contracts provides disincentives for investors in rental housing. On the other hand, policies towards home ownership favour high-income groups. Social housing construction programmes can only partly compensate these defects. First, they are expensive, providing housing far below market prices and shifting investment risks largely to public budgets. Second, for the same reasons they discourage investors from entering the private rented sector.

THE IMPACT ON HOUSING FINANCE

By a change in tenure policies, much more capital of private and institutional investors could be released to flow into residential construction and upgrading. This would affect the volume of housing finance.

**Figure 1**: Home Ownership Finance by Social Status

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<tr>
<th></th>
<th>Self-employed</th>
<th>White-Collars</th>
<th>Others</th>
<th>Blue-Collars</th>
<th>Average</th>
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<td><strong>percent</strong></td>
<td>30</td>
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a) Share of home ownership cost in current income

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b) Share of down payments in house prices
Apart from that, substantial effects on the structure of housing finance should be expected. The pattern of tenure policies prevailing in industrial countries like Germany implies that the allocation of risks in the economy is distorted. We have to recognise that in those countries capital markets are well established and function efficiently, while at the same time the availability of public money is restricted. In these circumstances, a large share of social housing programmes in public expenditure on housing implies that the government assumes too much of the market risk on capital. By shifting tenure policies, the market risk should be shifted to investors and their creditors.

On the other hand, the extent of the default risk the banks are prepared to assume is restricted. Hence, low income households are exposed to credit rationing, if they apply for owner occupation. In particular, German banks practice prudential lending to owner-occupiers. Securitisation of mortgages is offered up to 60% of the "lending value," that is less than 50% of the market value of a building. About 20% of value is usually refinanced by intermediation, leaving interest rate risks with the borrower. Alternatively, German building and loan associations provide these "second" mortgages, exposing the borrower to a higher front-load burden. As a rule, 25% to 30% of value is required as a down-payment. This lending practice is enforced by applying 'burden' criteria which define the minimum consumption level as a percentage of current income. The lower current income is, the higher the required down-payment has to be. Consequently, the risk of default due to house price volatility is low in German housing finance. Bankers claim that there is no need to introduce mortgage insurance. On the other hand, a worker's household with median income is not eligible for home ownership, because they normally cannot make the high down-payments.

The effective access barrier to home ownership for low income households is partly due to the design of housing finance instruments (constant rate annuities). An earner who is capable of bearing an increasing rent burden over time (which will be matched by his or her expected higher incomes) is nonetheless not able to finance an equivalent annuity out of current income. The reason is that a borrower has to bridge a liquidity gap during the first years of a mortgage.

This 'frontloading problem' in housing finance may be illustrated by the following example. Suppose the initial rent per month for a newly built dwelling is DM 13.40 per square metre. The interest rate is 7% p.a., and rent increases of 2% p.a. are expected. If the tenant decides to buy this dwelling, he or she will have to pay DM 3,500 per square metre. The bank will finance the transaction, but will require a down payment of approximately 25% of the property's value. The tenant may have sufficiently high savings balances to deliver the down payment. Even then, the household's liquidity requirements will be increased by the tenure change. Home ownership lays an additional burden on current income compared to the tenant's status. In our example, annuity payments (on a credit of DM 2,600, covering an interest rate of 7% p.a. and a redemption rate of 1% p.a.) amount to DM 17.33 per month.

As Figure 2 shows, the home owner is definitely disadvantaged in terms of liquidity during the first twelve years. However, the tenant's liquidity status continuously deteriorates due to rent increases. Consequently, the home owner will be better off after a "break-even" point is passed.

The front-loading problem in traditional housing finance is well known. It determines the default risk, and is a major reason for down payment requirements. It should be stressed, and the example should have made clear that there is essentially a liquidity problem. The crucial point is that creditors - for good reasons - are not prepared to lend on the basis of a household's expectation of rising income. If they did, the household's current burden could be shifted to m1 which indicates that the household's liquidity constraint is independent of its tenure status.

We may come to a first conclusion. The liquidity constraint on home ownership is relatively high for households with low

Figure 2: Liquidity Constraints by Tenure

![Figure 2: Liquidity Constraints by Tenure](image-url)
equity and/or households with high income expectations in relation to their current incomes. These are specifically "younger households"—the earner is younger than 35 and is still in the initial phase of his or her professional career. Within this group, households with children are particularly disadvantaged because their ability to save out of current income is relatively low.

The front-loading problem is aggravated by inflation. Suppose that inflationary expectations increase. That will raise the long term interest rate, but also expected rent increases will be higher. With a higher risk of interest rate volatility, creditors will demand compensation. Hence, the interest rate will increase by more than inflationary expectations. If inflationary expectations increase by one percentage point, the interest rate may shift to 8.5% p.a. in our example. Accordingly, the expected rent increase will rise to 3% p.a. In that scenario, the liquidity requirement of a home buyer increases relatively to the tenant's. Although the "real cost" of a home buyer is not increased, in so far as the rise in annuity payments indicates a rise in real principal, he or she nonetheless will suffer a cut in disposable income. Hence, access barriers to home ownership for low income households will be increased by inflation.

Consequently, an innovation in housing finance instruments combined with a shift in government intervention could substantially improve access to home ownership. What this market constellation requires is not more public money but a shift in risk allocation. Basically, there are three options for a reform of the housing finance system.

**OPTIONS OF HOUSING FINANCE REFORM**

First, the risk may be shifted back to the borrower, who is required to deliver a higher downpayment. This is a case for housing contract saving which provides a considerable share of mortgage finance in countries like Germany and Austria.

What makes the Bauspar-option attractive? Principally, Bauspar banks offer loans on the basis of specific housing savings contracts in which borrowers have to make regular deposits in advance until a certain savings target is achieved. There is no connection to the capital market. Hence, the system works without any interest rate risk for the institution. A mismatch between supply and demand of funds within the system is responded to by queuing. Hence, the waiting period for an individual borrower is uncertain in advance, depending not only on his or her personal savings schedule but also on the dynamics of the overall system. Interest rates for deposits as well as for loans are fixed and below market rates. The spread is usually two percentage points.

Depending on the volatility of market interest rates, the contract savings and loans system may have substantial redistributive effects. Mainly for this reason, and to keep waiting periods under control, repayment periods are kept short, on average 10 - 12 years. Consequently, borrowers are charged with high principal payments and, hence, are confronted with a special 'frontload problem'. In addition, the cost of home ownership is partly shifted back to the savings period. Even in a period of moderate inflation, long term savings contracts yield 7-8%, compared to 2.5-3% for housing contract savings. That certainly balances low mortgage interest rates. The real advantage seems to be, therefore, that Bausparkassen promise to provide a loan (at an uncertain date in the future) without any specific underwriting procedure and at fixed terms (when the loan is paid, the borrower usually has to contract a life insurance policy; hence, an essential part of the default risk is covered). Thus, Bauspar loans appear to be particularly advantageous for low-income households and/or first-time home buyers.

From the bank's viewpoint, there is an economic rationality in such savings schemes. A main problem for creditors is the lack of information as to the credibility of the mortgage borrowers. That kind of uncertainty is reduced if households have demonstrated for several years their reliability in serving savings schemes. Furthermore, young households learn that a commitment to regular saving pays off.

Consequently, the expected default risk is reduced and creditors are prepared to offer credits to low income households on a broader scale and/or at more favourable conditions than otherwise. As an economist I would judge such a change as an improvement in the functioning of mortgage markets.

Governments have an interest, therefore, in providing incentives for contract saving schemes. This is particularly the case, if promotion of home ownership belongs to the major objectives of housing policy, as in Germany. Options for government intervention are:

- Tax exemption on interest payments (in Germany, capital income up to DM 6,100 per year and person is tax exempt);
- Premiums on savings payments, in particular for younger households (in Germany, means-tested premiums with caps are paid which provide an incentive to low income (young) couples to save up to DM 40,000 within 15 years; income ceilings are so low, however, that most unmarried persons will be ineligible as soon as they have started their professional careers).

The problem with high down payment requirements is that most households have to save out of current income in order to meet that restriction. Saving takes time. Hence, low income households, in particular households with children, have only late in their life cycles reached a wealth status to afford home ownership.

In Germany, the average age of first time home buyers is 38. For many families that may be an age when they expect their children to leave their parents' homes within a few years. If housing policy intends to promote home ownership for families, it
should provide schemes, therefore, which enable families to buy their homes at an earlier date.

This objective is met by a second option of housing policy reform. Basically, it requires that households may borrow against expected income instead of current income. In the case of younger families that would make a big difference, because these households are in a phase of their personal career, when real income expectations are high but current incomes are low. In Germany, personal real income increases, on the average, when earners are between 25 and 35 years old.

From the banks’ viewpoint, the provision of home ownership to younger households would require them to accept lower down payments as these households are in an earlier phase of their economic cycle. Correspondingly, redemption periods would be longer. Nonetheless, the banks would have to assume an extra risk as the households’ income expectations are uncertain. In order to make such a scheme viable, this extra risk has to be taken over by the government.

As to the design of such a scheme, the banks have to provide additional finance in order to reduce the households’ liquidity constraints. The amount of extra finance which is necessary - and the additional risk which has to be shifted to the government - is determined by two factors. First, loan-to-value ratios will be higher from the beginning as a consequence of reduced down payments. Secondly, payments on the debt have to be tailored according to the expected development of real incomes. To fulfil that second requirement would be a real innovation in housing finance. It means that payments should be low during the first years but may be increased continually according to the expected rise in real income. Keeping the real burden on current income constant - or even rising - requires a variable annuity on the debt. Ideally, such a scheme would put the household in the same liquidity position as a tenant (m1 in figure 2).

Consequently, the loan-to-value ratio will increase over a certain period of years (approximately 10 to 15), that is until the annuity has risen to an amount which covers interest as well as real redemption. It is just this risk of a rising loan-to-value ratio which has to be shifted to the government.

From the government’s viewpoint, taking a fiscal risk in housing finance would nonetheless leave the government better off than assisting low income households to overcome their liquidity constraints by public grants or public (low interest) credits.

The economic rationality is that the government essentially provides insurance against default risk, thus reducing the risk on average. The scheme opens up mortgage finance at normal conditions to low income households which would otherwise be confronted with access barriers in housing finance. Even if they were prepared to pay higher interest rates on mortgages to compensate the bank for the extra risk, the bank would not accept such an offer. In economic terms, the bank always has to be aware that by setting different interest rates, a selection of borrowers may imply a selection of bad risks.

The government would have to apply underwriting requirements in order to restrict that kind of ‘real cost’ of such a scheme. Nonetheless, due to the risk-pooling effect, the government may still have lower costs than with traditional programmes of public expenditure on housing.

There are several countries which provide an incentive to creditors to offer additional housing finance to low income households by assuming the extra risk, i.e. by securing against the risk connected with an increase in the loan-to-value ratio. This is for instance the case in the Netherlands, where the government offers means-tested public mortgage insurance.

There is a third option of housing finance reform which is concerned with an assign-
presumably allocated efficiently. Interest rates on mortgages can be lower than otherwise. German mortgage banks and, to some degree savings banks, pursue that kind of securitisation, although on a restricted scale.

German mortgage banks may offer only two main types of loans, mortgages and loans to municipal corporations, but they are authorised to securitise their assets. They issue mortgage backed securities and municipal bonds, thereby covering these securities by separate pools of mortgages and municipal loans respectively.

Mortgage backed securities in Germany are not 'pass-throughs' as in the United States, but are issued on account of the mortgage bank. The default risk is restricted by a legal underwriting standard which limits the amount of a mortgage to 60% of the mortgageable value of a property. This standard for mortgages which qualify for securitisation has been adopted by other lenders and was established as a general rule for 'first' mortgages by the Kreditwesengesetz in 1985.

Although that kind of securitisation provides for long-term fixed interest rates and reduced spreads, it is restricted to limited loan-to-value ratios. Evidently, securitisation on a broader scale is required to provide low-income households with mortgages at favourable terms, in particular long-term fixed interest rates.

It is government guarantees which open up this opportunity. If the property value is not sufficient as collateral, so that credit rationing would take place without government intervention, the government should assume the extra risk. Hence, government risk bearing takes a dual role. It overcomes the liquidity constraint for low-income households, and at the same time provides for long-term finance at fixed and favourable terms for this social group. The fiscal impact of such a scheme of social housing policy should be rather limited. What is required is the design of new instruments of housing finance.

Building and Social Housing Foundation

International Study Visit:
Indore, India, 6 - 10 February 1995

The Building and Social Housing Foundation is organising a 5 day study visit to the award winning Indore Habitat Project in India.

The Indore Habitat Project provides an innovative city-wide approach to urban improvement through the networking of slums and other distress zones in the city. Incorporating full community support, the project has brought dramatically improved living conditions to 900,000 people at a fraction of the cost of conventional approaches. This approach is based on the comprehensive development of urban infrastructure - stimulating economic growth and alleviating daily hardship.

Bursaries may be available to meet the travel and accommodation costs of representatives from developing countries who wish to participate in this study visit.

Bursary application forms and further details can be obtained from:

Mrs Diane Diacon
Research Officer
Building and Social Housing Foundation
Memorial Square
Coalville
Leicestershire
LE67 3TU
United Kingdom

Tel : +44 530 510444
Fax : +44 530 510332