Models in Mortgage Protection: European Evidence

by Achim Dübel

INTRODUCTION

This article summarizes the results of a study undertaken by the author for the German Federal Ministry for Regional Planning, Building and Urban Development. Results for the United Kingdom, France, Germany, Belgium, Sweden and Switzerland are reported.

The background to the study is the persistently low German homeownership rate of only 40.2% (following 1993 Income and Expenditure Survey). Despite historically low interest rates, a stable house price environment and a change in homeownership assistance scheme in 1996 that favored middle-income households, homeownership formation has remained sluggish in Germany. One of the reasons may be seen in the mortgage banking sector that has long departed from the traditional loan-to-value based underwriting standards and does not accept households with high potential revenue risks.

Despite the fact that homeownership assistance takes the form of a buy down over eight years, lenders do perceive it as an equity substitute, not as a cushion for temporary affordability gaps. Since German lenders tend to reduce credit risk in absolute terms rather than to price it, housing policy makers are seeking for mortgage protection instruments that could serve to enhance mortgage market penetration.

The perspective of countries with higher homeownership rates differs: most of these countries have faced around 1990 a credit-risk crisis that has seriously negatively affected mortgage lenders and insurers. In those European countries which were most affected, France and the United Kingdom, the insight about the need to develop alternatives to foreclosure has led to innovations in a number of areas, in particular concerning unemployment insurance.

Governments have become involved in generating own or supporting private mortgage protection schemes, with the aim to stabilize the financial sector, where necessary, and create cushions to the negative social consequences implied by high numbers of foreclosures.

MORTGAGE FORECLOSURE AND MORTGAGE PROTECTION

Conceptual Issues

Disregarding national peculiarities, mortgage foreclosure has two primary economic deficiencies:

- There frequently exist alternatives that yield higher total returns which may be distributed to lenders, borrowers and insurers, for instance, from selling the house free-handedly or maintaining loan and homeownership current. Often, these alternatives have not been appropriately legally codified, or are economically blocked by a number of factors. This (paro-to-) inefficiency is often simply the result of a particular national tradition of approaching mortgage foreclosure.

- There is a dynamic inefficiency embedded in foreclosure, if the causes for default are only temporary revenue shortfalls or a liquidity problem. For instance, foreclosure exposes all involved parties unnecessarily to price risks that may be avoided if the loan stays current. This inefficiency is primarily caused by the incompleteness of insurance and mortgage markets.

Both aspects underline the fact that any loan management system needs a set of graduated responses to delinquency. Mortgage protection is defined here as the subset which would keep the mortgage loan current after a default, and thus avoid both foreclosure and a loss of dwelling and the loan relation. It will be particularly relevant in cases of revenue shortfalls due to temporary unemployment, temporary revenue losses of the family during lifecycle (e.g., as spouse takes childcare break), divorces, temporary

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mortgage cost increases, etc. Schemes thus focus on re-engineering, supporting or guaranteeing debt-service payments or loan cash flows, through:

- giving borrowers upon loan underwriting the option to self-adjust their debt service in case of revenue shortfalls, through loans that allow over- or underpayments and/or grace periods (flexible mortgages, or prêts modulables).

- negotiating with borrowers after a default rehabilitation plans that may include debt service reduction and capitalization, additional credit lines, forebearances and other debt workout components. Crucial issues here are the creation of a sufficiently large time slot and a regulated negotiation process, including counselling and mediation.

- insuring the debt service payments against the main relevant contingencies for a temporary loss of ability-to-pay.

- granting public income and mortgage costs support.

In contrast, both the political discussion and practical institutional solutions in the past have concentrated on mortgage (indemnity) insurance and instruments protecting the borrower from the consequences of overindebtedness. Both apply only when equity in the home is already depleted or losses from foreclosure have materialized.

In addition, traditional mortgage insurance compensates the lender, with private insurance schemes often holding the borrower liable for any residual claims. Where foreclosure avoidance is a political focus, often the perspective of a permanent loss of revenue is taken, placing mechanisms such as free-handed sale (pre-foreclosure), trading down and repurchase agreements (for loans) into the foreground.

Although it is primarily the borrower and society which benefit from mortgage protection schemes, lenders are increasingly interested in finding mechanisms to keep the mortgage loan, and ultimately a customer relationship, current. Below, a number of European models are discussed that have gained some economic and legal significance in protecting the credit relationship and thus allow for cautious evaluation.

**FRANCE**

**Overview**

Delinquency rates in mortgage finance in France reached high values at the beginning of the 1990s. Following indications of the Commission Bancaire, in December 1991, 13.9% of social housing loans and 4.4% of private market loans were in arrears or default. After the end of the real estate price cycle and the reduction of the interest-rate level in the mid-1990s, these rates have been reduced to normal levels again.

Foreclosure data are only indicative. Since judicial foreclosure is associated with a high risk of residual debt, the share of loans with foreclosure carried through to the end in total delinquent loans may be estimated at only 5% to 10%; in relation to the total loan stock a low figure of 0.05% to 0.2% is the result. France has a developed set of mortgage protection instruments that has been examined by Agence Nationale pour l'Information sur le Logement (1997).

**Private Sector Approaches**

- There exists a far-reaching credit supply for supply of credit with variable amortization and interest-rate capitalizations (Prêts Modulables). Credit Mutuel (market share approximately 14%) realizes the majority of its lending as flexible mortgages. The Savings Banks (market share approximately 11.5%) have picked up this credit form in 1992, and Credit Agricole is expected to follow. The typical limitation of the schemes is that the implied extension of duration shall not exceed two years. The typical durations of French mortgage loans is 15 to 20 years.

- There is private insurance against unemployment, accident, invalidity insurances (see below).

**Public Sector Approaches**

- Department commissions for the curing of overindebtedness situations were created by Loi Neiertz. In these commissions, representatives of the public sector are formally mediating so-called “friendly solutions,” i.e., rehabilitation plans between creditors and borrowers before litigation. To what extent the provisions of the Loi Neiertz has contributed to the high foreclosure avoidance ratio is highly disputed.

- Direct assistance schemes for homeowners (Section Departementales des Aides Personelles au Logement) and assistance funds for homeowners in financial difficulties (Fonds d'Aide aux Accedants et Diffcultes). These schemes are generally viewed as under-funded and inappropriate. They are managed at the local level (departements).

- Repurchase guarantees for privatized units through the social housing organizations (rachat HLM (habitation a loyer modere), primarily geared towards supporting tenant privatization.

- A guaranty fund for social housing loans (Fond de Garantie de L'Accession Sociale, see below).
Private Unemployment Insurance

Approximately 15% of mortgage borrowers are enrolled in private unemployment insurance schemes. These are offered as a part of the credit agreement by the majority of lenders. The lender closes a group contract with one of the four insurance companies that offer the product and acts as the originator for the insurance policy. Through the group contract the lender acquires the right of making calls to the insurance. Unemployment insurance policies feature widely varying guaranty forms with differing financial conditions. A typical example is the unemployment insurance scheme offered by Credit Lyonnais.

- **Access**: employment with social insurance after the probation period, or equivalent safety net in the case of self employed.
- **Waiting period after underwriting until the first potential payment**: six months.
- **Franchise period after entry into unemployment**: 90 days.
- **Maximum covered period**: 18 months for each event of unemployment, for a total of 36 months over the entire duration of the contract.
- **Maximum covered debt service**: 11,000 FF per month.
- **Degree of coverage of debt service**: Option 1–50%, Option 2–75%, Option 3–100%.
- **Cost per 10,000 FF credit amount**: Option 1–0.3%, Option 2–0.45%, Option 3–0.6% per month. The insurer can adjust the premiums according to his cost situation over time.

Long franchise periods and graduated coverage ratios are designated to improve the incentive structure. Franchise periods imply that the loan has arrear status at an early stage, creating incentives for borrowers and lenders alike to enter into rehabilitation negotiations. Information about moral hazard in practice are, however, contradictory: A traditional mortgage lender claims that the behavior of both lenders and borrowers changes fundamentally in the presence of unemployment insurance, and the rehabilitation process is slowed down. Other observers maintain that lenders often do not inform borrowers about the existence of unemployment insurance and enter hastily into rehabilitation agreements.

The insurers have sustained high initial losses because of greatly increased unemployment and adverse selection. Since raising premiums could cause additional adverse selection, insurers urge lenders in group contracts to market the product more actively. Also, franchise periods have been increased, and contracts with graduated payments have been introduced. Another solution against adverse selection is packaging with compulsory invalidity and accident insurance.

Insurance policies that fully compensate for the revenue losses are expensive, putting the lender into a conflict between accepting competitive disadvantages and taking higher credit risk. For this reason Union Compagnie Bancaire (UCB) practices a low-cost alternative, "garantie chomage." Under this scheme, the debt service of the borrower will be lowered automatically upon entry into unemployment (e.g., to 0.5%) and unpaid interest and amortization will be capitalized. The insurer reimburses the creditor for the full shortfall, i.e., a higher amount under an unemployment insurance, against a claim against the borrower for the capitalized payments at the end of the credit duration.

While the "garantie chomage" covers two unemployment periods up to 18 months each, borrowers are offered a true unemployment insurance for any additional periods of unemployment. Since a future liability of the borrower is created, the insurance can bear lower costs as well as a lower risk of moral hazard on the side of borrowers and creditors. Thus the costs of the contract are only 0.75 FF per month per 10,000 FF credit amount compared with typically 2.5—5 FF per month for true unemployment insurance. However, UCB encounters adverse selection by making "garantie chomage" compulsory.

**Public Mortgage Insurance/Fond de Garantie de L'Accession Sociale (FGAS)**

FGAS guarantees since 1993 the outstanding capital of the most common, only weakly regulated private bank loans (Prêts Conventionnes, PC)³ which by this action turn into social loans (Prêts de l'Accession Sociale, PAS). Moreover, since 1995, the main instrument of French homeownership assistance, an interest-free loan with variable grace periods depending on income and location (Pret a Taux Zero), is insured under FGAS. The value of the credit guaranty of FGAS has been estimated by M. Gaudin in a 1996 study at approximately 0.6%. A major point is that FGAS-insured loans bear a risk-weight of only 15% (instead of 50%).

FGAS is funded through joint contributions of government and lenders over 1.25% of the credit amount each, up-front, as well as monthly payments of the borrower (0.2%). While the fund is owned by the participating lenders, the government takes over recourse for the insolvency of FGAS. So far, FGAS is a pure mortgage indemnity insurance scheme compensating the lender for cash-flow and principal shortfalls. The introduction of mortgage protection schemes is, however, envisaged.
The model is interesting because of its mechanism for the creation of incentive compatibility, the combination of "mutualization" and "responsibilization." While "mutualization" denotes the principle of a common funding of the insurance pool, "responsibilization" describes the feature that the claims of each lender on the fund are limited to a maximum amount for each credit vintage.

Thus, higher than expected credit losses are absorbed by the lender. However, both the lenders and the fund are protected against catastrophic risk. If the credit losses of a given credit vintage exceed a second threshold, the government completely covers the excess loss incurred. For instance, in phases of high unemployment, or loan vintages being closed during house price booms with high price risk, government protects the system.

**UNITED KINGDOM**

**Overview**

The British mortgage lending and insurance industry underwent a credit risk wave at the beginning of the 1990s that continues to have an impact on the industry. Between 1988 and 1992 the share of loans in arrears to total outstanding mortgages increased more than sixfold, and the corresponding share of loans in repossession more than tripled. At the height of the crisis in 1991, loans in repossession made up 0.77% of outstanding mortgage loans. In 1997 this value still amounts to 0.4%. The relation between repossessions and arrears indicates a swift enforcement of judicial foreclosure: over the years 1988 to 1997, the annual average ratio between loans in arrears and loans in repossession was four to one.

After an initial phase that was characterized by the ad-hoc introduction of expensive and insufficient subsidy and insurance schemes, the system has gradually matured:

- In about two-thirds of arrears cases during the debt crisis, negotiated rehabilitation plans between borrower and lender were reached (Ford et al., 1995). The most common forms of re-engineering cash flows were: agreements over lump-sum payments for arrears and resumption of debt service, and permanent reduction of debt service. Increases of loan duration, forbearances and interest-rate capitalization were uncommon at the time. More recently the Council of Mortgage Lenders (CML) has issued a statement of practice for the treatment of interest arrears and repossession (CML 1997). In order to manage negotiations thus codified, a specialized industry of professional arrears counsellors has appeared. This industry self-indicates an 80% success ratio.

- There is a private mortgage insurance industry that offers both mortgage indemnity insurance and increasingly mortgage protection plans (see below).

- There is an increasing supply of flexible mortgages (see below).

- Public income support and mortgage-interest support for homeowners is particularly generous (see below).

**Flexible Mortgages**

The market share of flexible mortgages was 2% in 1997, and is expected to quadruple in 1998. According to a survey by CML, the borrower can acquire a number of options upon underwriting:

- Acceleration of amortizations, in general without maximum amount.
- Grace periods, decelerating or negative amortizations. These options are frequently used for the management of temporary revenue shortfalls. They are offered by all creditors; frequently maximum amounts apply (e.g., 6 months interest rate payments, reduction of debt service by 2%).
- Conversion of mortgage accounts into current accounts, with possibility of periodic under- and overpayments.

Flexible mortgages are generally viewed as a short-term solution in case of revenue shortfalls, in particular against the background of the nine months waiting period for public mortgage interest support (ISMI).

**Mortgage Protection Plans**

Mortgage protection plans (MPP) represent a package of insurance policies protecting the borrower against revenue shortfalls stemming from unemployment, accident and invalidity. They are offered through three-fourths of lenders as a private insurance product and are often made obligatory for certain debtor groups. After serious difficulties in the introductory years that coincided with the credit-risk crisis, MPPs have reached in 1997 a market share of 20% of outstanding and 40% to 50% of newly closed loans, despite continued media criticism. By virtue of the increased market share and supported by the economic recovery, the cost for insurers has declined. At present, following CML (1998) more than 80% of calls on the insurance are successful, up from under 20% in the early years.

The premiums for MPPs amount to 5%-7% of the debt service volume. Assuming 1% amortization and an interest rate level for adjustable rate loans of 7% would imply a mark-up of between 0.4% and 0.5%. One problem is that due to weak competition 60% of premium revenues cover administration cost and profit, and only 40%
actuarial cost. It is only since 1997 that one insurer offers the product for a premium of 1.5% of debt service volume.

In the United Kingdom, several concepts are discussed for improving the performance of MPPs. On one hand, it is envisaged to make mortgage protection compulsory, with the argument that the social safety net is insufficient to protect the mortgages, and adverse selection effects cannot be countered otherwise. The alternative, to undertake an actuarial pricing of the individual unemployment risk, could lead to a crowding out of entire borrower groups in the market. Pooling would reduce the risk premium through forced diversification. Also, the foundation of a re-insurance pool as a special purpose vehicle run by the mortgage insurance industry is discussed as a protective device for individual insurers against catastrophic events. Here, as in France, the industry has requested involvement of government.

**Income Support for Mortgage Interest (ISMI) and Mortgage Interest Direct (MID)**

ISMI has existed since 1935 and covers at present 50% of interest-rate cost for terms of 16 weeks but not the premiums for endowment loans or amortization payments. Prior to the introduction of MID in 1992, which now kicks in at the end of 16 weeks, 100% of costs were taken over. Most lenders are giving financial support for a system that transfers government payments directly to them. Figure 1 shows that while the entire subsidy volume for homeowners has been substantially reduced over the past decade due to the reduction of tax incentives, the support volume through ISMI has grown substantially. Even after the credit risk situation improved, ISMI payments have only weakly declined, despite drastic reductions of benefits in 1995.

In order to cushion costs, since 1995 the interest rates that are underlying the calculations of the interest cost are fixed by government. In addition there is now a franchise period of nine months until first entitlement for payments, i.e., it is expected that the borrower uses payments of mortgage protection plans or own savings to cover the debt service payment. However, empirical surveys show that the risk of unemployment is independent of enrollment in MPPs. In addition, the risk of divorce is not insured by MPP, and many borrowers are not accepted by the insurers, creating additional gaps in the protection system. The synchronization of MPP and ISMI is thus problematic, at least as long as MPPs are not made compulsory.

Unsurprisingly, ISMI features strong incentive compatibility problems. On the one hand the administration may compel a household to trade down the house through moving into a cheaper accommodation. On the other hand, ISMI covers mortgages up to £100,000, while average house prices Figure 1. Default Indicators, Expenditures for Income Support for Mortgage Interest and Total Subsidies for Homeowners in the UK, 1988–1994

![Graph showing default indicators and expenditures](image)

are only approximately £60,000. Moreover, payments are made for an unlimited time period, which creates disincentives for resumption of work and negotiation of debt rehabilitation plans. Against these arguments it is held that payment of ISMI is less expensive than payments of housing allowances for private rental housing or the provision of a council housing unit.

GERMANY

Overview

Default and loss incidence in mortgage lending in Germany has been traditionally low. The author estimates that mortgage foreclosure in 1997 affected approximately 0.06% to 0.12% of outstanding mortgage loan contracts, and that approximately a third of non-technical defaults end in foreclosure. Nevertheless, it is a social problem since borrowers, under the present laws, are entirely liable for residual debt after foreclosure; i.e., there is no discharge. Mortgage protection is hardly developed:

- Private debt workout schemes are the rule. However, they are seriously handicapped by the typical funding scheme through multiple loans (first and second mortgage, or Bauspar (contract savings) loan, and personal loan). Mutual creditor information is generally absent before foreclosure is opened, creditor coordination in rehabilitation plans is generally ad-hoc and dominated by the different interests of creditors in different ranks. Because of differences in lender’s interest, time horizons between default and the call of the loan may vary between six months and two years.

- Because of the traditional absence of high-risk mortgage lending, there is no German mortgage insurance industry to speak of, although some lenders/insurers offer mortgage indemnity insurance in limited cases.

- The general social system generally supports households in need generously, but it is not targeted towards homeowners. With high house prices (average house price to income ratio of 8), real values of debt are high, as defaults occur typically in the first years and even high wage replacement ratios are insufficient. While homeownership allowances exist that apply to the unemployed (Lastenzuschuß), the income limits are too narrow to support the debt service capacity of households. Homeownership assistance is generous, but it supports primarily equity substitution (i.e., improves market penetration), but not the case of a temporary revenue shortfall.

- Trading down and free-handed sale is seriously impaired by the high level of transaction costs.

State Mortgage Protection Scheme (Social Housing)

State mortgage protection in social housing represents an interesting approach to the problem of multiple-creditor coordination. Loans for social housing programs in North Rhine-Westphalia are extended by Wohnungsbauförderungsanstalt (WFA), which enjoys degrees of freedom in managing defaults just as a private lender. It also manages public loan guarantee programs.

WFA is well aware of problems a second mortgage lender has in a multiple-creditor system: Instead of observing the ordinary notice procedures employed by banks, which may lead to information delays of two months and more, they approach every six months approximately 25% of their technical default cases directly in order to identify the economic defaults as early as possible and be able to initiate own-debt negotiation procedures.

Default management is differentiated by eligibility. Under the state-run mortgage protection plan Wohneigentumssicherungshilfe (WESH), WFA is entitled to use budgeted “funding” ("Mitteleinsatz") for debt workouts, either loans or subsidies. Independently from WESH, WFA can operate just as any lender in supporting debt workouts, if it is in their own interest. Eligible for WESH are homeowner families with one or more children, or a disabled partner, provided that they have received a public loan in the past and continue to fall under the income limits of social housing. The motivation is both to help needy families and to protect state-owned assets (the public loans). The ministry cites as an economic rationale behind supporting low-income homeowners in default the need to avoid public expenses for new social housing units (approximately DM 140,000 per unit).

WESH establishes an institutionalized process of intensive care-taking for the household over a period of six years. After a preexamination, a wealth profile of the household is undertaken as a basis for the workout plan. A financial advisor is appointed to the household; he may come from a Debt Advisory Board ("Schuldnernberatungsstelle") or a bank. As private lenders know of this procedure, they refer defaulting clients to apply to WESH in order to save workout coordination costs and improve their arrears-management results. The consultation frequency of WFA through first mortgage and Bauspar lenders is thus reported as high.

If the debtor becomes eligible for WESH, consumer loans can be prepaid by WFA and converted into a real estate loan (under much better general interest-rate conditions). Rehabilitation loans, however, should cover more than the consumer credit portion, as the condition is that, after deducting debt service for the real estate loan, residual income must be insufficient. Hence, parts of the private loans are converted as well.
The additional loan is inscribed into the land register to block further encumbrance of the debtor and give the credit market a clear default signal. The additional loan will amortize at rates of 5% to 7%, i.e., with a medium velocity between a standard consumer loan and a real estate loan. It will typically be interest-free for the entire duration, i.e., the workout period thus defined is fairly long. Second defaults may be handled with additional loans (“Nachsorge”). In total, approximately 10% to 15% of WESH loans experience second defaults, of which some enter foreclosure. Despite the technical possibility of doing so, WFA does not use public loan guarantees.

Distribution of losses in the workout cases is not clearly identifiable. However, WFA claims to have a reputation for demanding strong commitment both from the creditors of the consumer loans and the better-ranked creditors. Although losses are asymmetrically distributed by rank, depending on the degree of debt subordination, WFA claims to solve most situations without overproportional burden on the state. However, if consumer credit is prepaid, those creditors are clearly bailed out. Moreover, experience shows that some first mortgage lenders and creditors of consumer loans are identical, hinting at significant moral hazard problems in the system.

SWEDEN
Overview

The continued real estate crisis in Sweden at the beginning of the 1990s brought about significant default problems, despite a low homeownership ratio (40.6% in 1990). AB Spintab, the second largest mortgage lender, lost over 0.7% of outstanding loans in 1992, and after that only a slow stabilization took place. Housing production dropped from 70,000 units in 1991 to 10,000 in the mid-1990s.

Because of the form of homeownership assistance which featured a basically unlimited interest deductibility from taxable income, property ownership is concentrated in Sweden in the high income brackets. Residential credit losses in the past have thus mainly affected cooperative property and the private rental housing sector. While a mortgage protection system is still hardly developed, there are some interesting aspects:

- Before 1992, second mortgages were generally funded by a public mortgage loan, the stadsenshypothek. Debt workouts in the past have thus been solved to a large extent at the expense of the state. A frequent arrangement was to provide for a free-handed sale of the house, implying typically a complete loss on the second mortgage, pay out the old mortgagee and purchase a new house with a new mortgage (often from the same lender).

- The Swedish consumer credit act knows the eventual liability of creditors for credit amounts which obviously exceed the ability-to-pay of the borrower. Overindebted borrowers, moreover, enjoy a discharge.

- Repurchase guaranty of the national labor market board: Unemployed persons who have to move because of a new job offer can put their house to the NLMB for the tax value (75% of the market value). If the indebtedness is higher, the value of indebtedness is applied.

- National guaranty fund. There is public mortgage insurance that has recently introduced mortgage protection elements (see below).

- No public mortgage protection instruments other than general social safety net provisions (income support) could be identified.

National Guaranty Fund/Statens Bostadsknutitnämnd

Since July 1992 housing loans in Sweden are entirely provided by the credit market. When this change was enacted, the state started to issue credit guarantees in order to stabilize the real estate market. For this purpose a new authority was introduced, Statens Bostadskreditnämnd (BKN).

The guaranty extends to all property forms and is offered against a fee of 50 bp. The fee income has not covered costs in the past. However, the high losses of the initial years—1994 and 1995—resulted from special underwriting conditions in place during 1992 and 1993.

The lender is offered comprehensive coverage of outstanding principal, interest arrears, legal and other costs. The maximum duration of the guaranty is 25 years and includes new and reconstruction. Fifteen percent of the outstanding guarantees of BKN cover owner-occupied housing. The amount guaranteed is a maximum 75% (1999–1995, 40%) of the acceptable production costs, for credit exceeding the first mortgage up to 100% of these costs. Production cost may differ from open market prices. A maximum guaranty amount will be calculated according to formulae which also applies to the homeownership assistance model and operates with maximum square meter costs (maximum 365,000 SEK). The guaranty may be increased by an annual rate of 1%, up to a total ceiling of 10% (40% in rural areas).

This feature allows to some extent for capitalization, or support of debt service re-engineering. In principle, the fund was intended to support the ailing mortgage industry through guaranteeing losses.
Table 1. Synopsis Instruments of Mortgage Protection in Selected Countries

<table>
<thead>
<tr>
<th>FINANCIAL STATUS</th>
<th>MORTGAGE PROTECTION</th>
<th>MITIGATION OF FORECLOSURE IMPACT (SELECTION)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Arrears</td>
<td>Foreclosure/Repossession Overindebtedness</td>
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| Instrument       | Instrument           | Economically Significant or with Strong Government Support In . .  
| PRIVATE SECTOR   |                      |                                             |
| a) Credit        | Flexible Mortgages   | France, UK*                                 |
|                  | Debt Workouts/       |                                             |
|                  | Renegotiation        |                                            |
| b) Insurance     | Mortgage Protection  | Free-handed Sale                             |
|                  | Insurances           | USA*                                        |
|                  | • Unemployment       |                                             |
|                  | • Accident/Invalidity|                                             |
|                  | Private Repurchase   |                                             |
|                  | Guarantees           |                                             |
|                  | • Real Estate        |                                             |
|                  | (mortgage rescue)    |                                             |
| PUBLIC SECTOR    |                      |                                             |
| a) Direct Assistance | Housing Allowances, | Support Free-handed                        |
|                  | Mortgage Interest    | USA                                          |
|                  | Support             |                                             |
|                  | Income Support       |                                             |
|                  | Support for Workouts |                                             |
|                  | Purchase of Private  |                                             |
|                  | Insurance Services   |                                             |
| b) Credit        | Public Loans         |                                             |
| c) Insurance     | Public Loan Interest |                                             |
|                  | Rate Caps            |                                             |
|                  | Public Repurchase    |                                             |
|                  | Guarantees           |                                             |
|                  | • Mortgage Loans     |                                             |
|                  | • Real Estate        |                                             |
|                  | USA*                 |                                             |
|                  | France, Germany      |                                             |
|                  | Belgium (Wallonia)*  |                                             |
|                  | France, Germany      |                                             |
| * Main policy focus|                      |                                             |

34 HOUSING FINANCE INTERNATIONAL
incurred after foreclosure. Since July 1995, however, a default management program has been introduced to help avoid foreclosure under the following circumstances:

- the return from a rehabilitation plan to which the fund contributes is at least 25% higher than the return from foreclosure, and
- a risk-split between lender and guarantor is reached.

The average cost reduction effect of such amicable solutions is today estimated at 30%. In practice, the program mainly applies to cooperatives.

OTHER EUROPEAN COUNTRIES

Belgium/Brussels and Wallonia

There is compulsory privately provided insurance against losses in mortgage debt service capacity caused by unemployment in the regions of Brussels and Wallonia. The premiums for the insurance policy are completely funded by the public sector. Once a year, a tender procedure takes place in which all suited insurance companies of Belgium are encouraged to submit offers to insure all newly closed loans of the coming year. Typically two to three insurance companies participate.

The relevant tender price is the insurance premium per unemployment case. The government reimburses the insurance company the contract price (known and constant) multiplied by the number of application cases that is unknown in advance. Thus, government bears catastrophic risk through underestimation of the volume of applications as a consequence of a rise in unemployment. The annual costs of the program are approximately 50–90 billion BEFs; and per insured loan approximately 0.31%.

All borrowers can apply for enrollment with the housing ministry, irrespective of income and whether the use after loan is the funding of new construction, acquisition of stock, or modernization and restructuring. Refinancings are excluded from mortgage protection. The guaranty can be called upon the part of the debt service for a maximum of the three years, during the first eight years of the loan. In contrast to the French system, there are no franchise periods. The amount of the protected debt service payment is capped.

Because of the global and compulsory character of insurance, there are no individual risk evaluations upon underwriting. As with other similar programs, only about 10% of the total potentially covered borrowers apply for enrollment. As one reason, lack of information about the system through banks and insurance companies is mentioned.

Switzerland

Switzerland features a general real estate repurchase program that applies as a module the so-called dynamic guaranteed mortgage finance program. Under the program which is at the core of Swiss homeownership assistance, debt service payments may be deferred following a schedule. The capitalized portions are guaranteed by the public sector. In order to avoid losses from calls on the guaranty, mortgaged dwellings can be repurchased by the state on a case-by-case basis. A publicly owned joint-stock real estate management corporation, SAPOMP WOHNBAU AG, has been commissioned by the federal housing office to acquire, manage and sell the properties for which public guarantees have been given.

The business goals of the corporation are protection of the guarantor government against insufficient foreclosure revenues that may hit its subordinate creditor position. As with other repurchase schemes, protection of the mortgage or homeownership is not a primary goal. In contrast, the corporation is compelled to keep turnover high and re-sell the units to new owners as soon as possible.

CONCLUSIONS

Mortgage protection schemes, if designed efficiently, are able to provide a feasible alternative to mortgage foreclosure and keep the loan current. In all surveyed countries, including those with a traditionally creditor-friendly legal environment, less than a third of economic defaults end in foreclosure. Appropriate credit or insurance solutions are severely handicapped, however, by the traditional focus of the legal system on foreclosure.

For instance, none of the surveyed countries, with the exception of France, has a clear, legally defined negotiation process between lender and borrower. Also, the time slots during which potential modals could be applied vary widely between countries (six months in Germany to 10 to 15 months in the Netherlands), between lender groups, and as a function of the negotiation powers of the borrower.

Moreover, the ultimate allocation of losses between creditors, borrowers and insurers typically remains a free negotiation process, depending on varying cooperation incentives. Interests of lenders and insurers thus frequently conflict with the interest of the borrower to safeguard the dwelling and/or the equity fixed in the house, leading to a sub-optimal solution.

Rather than reforming foreclosure legislation, which generally turns out to be a cumbersome task, policy makers, lenders and insurers have embarked upon national ways of creating a set of mechanisms for
keeping the loan current, none of which is consistent. However, countries hit strongly by the default crisis of the early 1990s have developed more comprehensive mechanisms than others. The experiences of France and the United Kingdom indicate that (1) a general codification of a loan rehabilitation process before foreclosure bears potential benefits for both lenders and borrowers; (2) flexible mortgages that help to increase the optionality for borrowers to self-manage revenue shortfall or liquidity crises are feasible, although not sufficient in a true economic default case; (3) the initial experiences with private unemployment insurance are promising, although important issues such as adverse selection and re-insurance against catastrophic risks remain to be resolved.

The results concerning the widespread mortgage indemnity insurance schemes for low-income households are mixed. Existing schemes may be re-gearred towards pre-foreclosure; however, experience suggests that incentive compatibility problems are delicate, in particular if a public insurer is involved. Continued public provision of mortgage indemnity insurance, as in the Netherlands, Sweden and the United States, may furthermore lead to the paradoxical result of a slow-down in the development and diversification of mortgage protection instruments in what is defined as the low-income segment vis-a-vis the remaining market. Furthermore, it bears the danger of a permanent horizontal market segmentation of the mortgage insurance market. Under these aspects, the Belgian model of public sponsoring of private unemployment insurance, or a mutual industry-public sector insurance concept as under the French FGAS, seem to be more promising avenues.

A non-negligible aspect, if one is concentrating on private-sector solutions, is the trend towards disintermediation in mortgage finance. Technical problems with self- or lender-gear ed cash-flow re-engineering may occur if loans are funded through mortgage-backed securities and mortgage bonds. More importantly, with the advancing separation of origination, servicing, insurance and funding functions, higher coordination requirements for the different agents involved in a default arise. Against the background of inadequate and inflexible legal systems this is likely to give rise to continued conflicts over alternatives to mortgage foreclosures.

REFERENCES


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**NOTES**

1 The original country coverage included also the United States and the Netherlands.

2 The concepts of mortgage indemnity insurance and mortgage protection are often confused. Mortgage indemnity or guaranty insurance protects the lender in the event of default.

3 PS's are loans which underlay a certain convention between the lender and government. Among other things the interest rate level must not exceed a reference rate that is fixed by Credit Foncier de France.

4 No insurance scheme against divorce risk could be identified.