Housing Finance in Israel

by Doron Nachmany

the end of 1998, some 2.7 million people emigrated to Israel.

This phenomenon of massive human influx, enormous for a country of Israel's size and density, occurred in waves, stimulated by both internal and external events. The main catalysts were:

1. The establishment of the State of Israel in 1948—Independence was followed by an immediate massive immigration that doubled the population within three years.

2. Israel's military victory in the 1967 war—a resultant surge of Jewish pride around the world refreshed the by-then slackened immigration flow.

3. The collapse of the Soviet Union—between 1990 and 1998 nearly 300,000 people embraced Israel as their new home and land of opportunity. Altogether, immigration has contributed almost half of the addition to the population over the years. (See Figure 1 and Table 1.)

The need to provide housing at short notice to vast numbers of households, especially in a young state with an underdeveloped economy and no effective private sector, dictated concerted efforts that were led by the public sector. Altogether, housing starts amounted to 1.8-1.9 million homes over 50 years. This effort changed the economy, the standards of living and even the landscape of Israel.

The latest wave of immigration, which still continues, although at a slower pace, started in 1989, when Jews from the former Soviet Union were permitted by the Soviet authorities to emigrate to Israel. Immigration peaked in 1990, when 200,000 arrived in Is-

### Table 1. Demographics

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<td>Population (millions)</td>
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<td>3.0</td>
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<td>Pop. Density (per km²)</td>
<td>106</td>
<td>148</td>
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<td>Distribution by Age (%):</td>
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<td>0-14</td>
<td>36.0</td>
<td>32.9</td>
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<td>Life Expectancy:</td>
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<tr>
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Figure 1. Immigration into Israel, 1961–1997

Israel, and continued after 1991 at a slower pace. Altogether, about 880,000 immigrants arrived by the end of 1998; the projected number for 1999 is 60,000. This sudden surge of immigration created temporary problems of employment and housing, which were solved gradually over the years by the economic boom that followed the immigration.

CONSTRUCTION OF HOUSING

The role of government in the evolution of the Israeli economy was marked by the political conviction that only government could undertake efforts of the scale that was required in the nation's first years. The need to absorb large numbers of immigrants by an underdeveloped economy, engaged in a long war with its neighboring countries, and the reliance on capital import to finance the required investment dictated such an effort, and Israel developed a centrally planned economy.

Housing was defined as a national priority, one of the main tasks to be undertaken by the government. From the beginning, a goal was set to help the majority of immigrants own their homes. This policy dictated the nature and development of housing in Israel: homeownership is widespread—almost 75% of the population live in owner-occupied dwelling units—and rentals constitute a minor part of the market. Another important policy concerned the dispersion of immigrants to sparsely populated regions considered important to the country's development and security: rural areas, development towns and settlements along the newly established international borders.

The lack of privately owned rental stock in Israel is rooted in decades issued during World War II. Rent control was introduced in 1939 and created an excess demand for rented homes, almost entirely in the centers of large cities. Until it was raised in 1953, it created a value—"key money"—that became the property of the dweller and was traded in the market. This reality froze the market for many years, creating a large stock of homes that were subtracted from the free market and left at a compulsory, reduced rate.

Further on, discriminatory tax rules towards real estate income, as compared to financial and labor income, prevented the development of the free market for rental housing.

Demand Outran Supply

During the first years of the young state it was impossible for the construction industry to meet the demand created by the large numbers of new immigrants, and temporary solutions were adopted. Abandoned British military camps, vacant houses that belonged to Arab refugees who fled the country during the 1948–1949 war, tents, canvas structures and huts were all used to accommodate the new immigrants.
In 1953, some 200,000 people were still living in substandard conditions in huts and tents, in "Transition Camps" that were scattered all over the country. Over the next five years, construction of new homes managed to provide the necessary housing needed to replace the temporary housing solutions.

With no strong private sector to undertake the task of providing adequate housing, the government took responsibility for the supply of new homes by being directly involved in the construction of new homes. In the beginning, these new homes were built to accommodate new immigrants, and later units were built also for young couples and families living in substandard conditions.

Homes were supplied to families who were approved for housing by special committees formed by the government. Government building companies constructed mass-produced homes, with standards of the typical homes improving gradually over the years. In the first decade the size of the typical home was 30 square meters, and it grew to 48 square meters in the 1960s and to 70 in the 1970s.

Impact of 1967 War

The surge in immigration that followed the 1967 war increased the demand for housing. This increase was intensified by rising demand caused by the economic boom that followed the war and by the government's new and ambitious programs providing housing aid for young couples in the early 1970s.

The surge in construction that followed was insufficient to offset the excess demand, and prices of homes rose precipitously. The lag in the adjustment of supply proved dangerous, when in the mid-1970s supply peaked, unfortunately timed to coincide with the economic slowdown created by the world oil crisis. The excess supply caused a considerable drop in home prices and led to financial troubles in the construction industry that devastated many construction companies.

Private Sector Emerges

Over the years, but most noticeably in the last 20 years or so, a vigorous private sector, capable of undertaking large-scale projects, emerged in Israel. The government, aware of its increasing dispensability in the area of direct provision of housing, took measures to decrease its intervention.

Gradually, the government stopped building homes and concentrated instead on providing infrastructure for the private market and programs to foster homeownership opportunities. Indeed, the main instruments of government intervention in the housing market have been indirect: provisions of subsidized credit for underprivileged groups of prospective home buyers and release of state-owned land in areas that were marked for residential development.

The surge in immigration that occurred since 1989 threatened to provoke another housing crisis. Official expectations in 1990 were that the then-impending wave of immigration from the former Soviet Union would bring 1 million new immigrants to Israel within five years.

This would have necessitated the construction of 250,000 new homes in addition to the 100,000 needed during the same period to satisfy local demand. Such an undertaking looked impossible for the private sector, bearing in mind that in the years 1985 to 1989 construction of new homes, by then firmly in the hands of the private sector, averaged 20,000 per year. Accordingly, the government, reversing its course of disengagement from the housing construction market, intervened to ensure sufficient construction of new homes. (See Figure 2.)

The government, however, did not return to its original modus operandi of outright construction and sale. Instead, it accelerated its release of state land around development towns for housing, disbursed grants and subsidies to potential first-time home buyers, and provided purchase guarantees to building contractors to encourage housing starts.

All this achieved the anticipated acceleration of planning, increased pace of housing starts, construction of large numbers of dwelling units, speedy construction and development of various areas. Housing starts doubled to 42,000 in 1990 and quadrupled to 84,000 in 1991.

The threat of a housing shortage was overcome and housing prices remained stable. Altogether, construction of about 460,000 homes was started between 1990 and 1998, enough to meet the demand created by both immigration and the net local addition of new households.

As the rate of immigration dropped—the current rate of immigration is 50,000-60,000 annually—the government decreased its intervention, allowing market forces to regain control of housing development. Estimates for 1998 are that housing starts came down to 42,900, a significant decrease from the 51,000 started in 1997.

This decline was probably caused by the expectations of contractors regarding declining demand, which coincides with the slowdown of the economy. According to many analysts, these numbers are below the long-term needs nationally, which are estimated at 50,000 annually at the present rate of immigration.

FINANCING: THE ROLE OF THE GOVERNMENT

Throughout most of its history, Israel did not possess well-developed capital markets. Instead, the traditional tasks of such markets
Figure 2. Israel Housing Starts, 1960 to 1998 (in thousands of units)

were fulfilled by the government, which acted both as a financial intermediary and a regulator of capital flows. The economic justification for such a structure was the need to finance the huge investment needed to support the development of the young economy mainly from external sources, and the lack of private mechanisms that could undertake such an effort.

When private savings became a substantial source of funds, they were practically nationalized in order to replace the external debt by an internal one. The government took deposits from the private sector by issuing state obligations to institutional investors and channeled these borrowed funds to "appropriate" investment objectives, including the financing of its own current deficit.

In this nationalized environment, private banks acted on behalf of the government, taking deposits at terms set by the government and extending loans to designated borrowers at terms dictated by the government. Alternative investments were strictly regulated.

For example, until the last third of the 1980s, the government was almost solely responsible for the issuing of bonds; private companies were practically prevented from issuing bonds to finance their own needs. Those that were allowed to issue had to deposit most of the funds with the government. Consequently, until reforms in the capital markets reached the mortgage markets in 1990, almost no private credit was available to a prospective home buyer and access to home buying credit was limited to individual loans to designated borrowers entitled to government aid.

**Government Housing Programs**

A common goal of the government's various housing programs since 1971 has been to enable potential home buyers to purchase units. Instead of taking responsibility for the construction and the provision of homes, the government moved to supporting the demand for housing by providing the financing at preferential terms.

Using alternating sets of criteria to define eligibility for the programs (Eligible Borrowers) and the terms of the aid, the Ministry of Construction and Housing concentrated on providing subsidized credit to selected population groups. These were mainly immigrants, "young couples," people living in overcrowded conditions and families acquiring homes in development regions.

The terms of eligibility were determined by a system of "credit points," ensuring the socially progressive nature of the system. Among these criteria are the length of time since marriage, the number of children, the number of brothers and sisters of the applicants, etc.
Support for Private Savings

There were several efforts by the government to generate private savings for housing. In 1958, new saving plans were introduced, providing the participants with tax benefits, an above-average yield and an option to be included in government housing programs. These programs were improved in 1963 to allow for the inclusion of children as beneficiaries and several times thereafter by inclusion in designated building projects and a commitment to provide a minimal sum of credit.

These saving programs, based mainly on a monthly contribution by the individual, were followed by privately operated ones, beginning in 1975. However, despite these efforts, the rapid inflation of home prices, which exceeded that of income, rendered these saving programs insufficient, requiring additional heavy subsidization.

A new macroeconomic policy that was launched by the government in July 1985 spurred several changes in the capital markets and, consequently, in the way housing finance operates in Israel. The new policy, designed to generate a sharp disinflation, called for a drastic cut in government deficits and reduction of the role of the government in financial markets. Step by step, the government stopped absorbing private savings and lowered the degree of its intervention in the channeling of credit.

In this environment, suppliers of funds now sought optimal investment opportunities. Simultaneously, a new demand for private credit to finance investment in housing emerged, forcing the banks to adapt to the new opportunities. In 1990, the government stopped providing credit directly to most of the “young couples” and instead let the banks provide the loans from their own sources, though the government still subsidized the interest rates.

The banks, thrust into lending to these borrowers, began lending at their own risk. They originated loans to most of the “young couples,” while for those still entitled to government loans they began lending complementary loans, in excess of the basic government loans.

Although the government planned to transfer gradually the major role of financing to the banks, the need to finance housing for the unexpected wave of immigration from the former Soviet Union postponed implementation for several years. For example, in 1991 the large numbers of immigrants acquiring homes and relying on extensive sums of government loans returned the banks to a situation where the share of government loans in total origination increased from the previous year. Subsequently, the demand for housing by immigrants decreased, and the privatization trend resumed its course.

FINANCE INSTITUTIONS

Housing loan origination and servicing are handled in Israel almost exclusively by specialized mortgage banks, most of them wholly or partially owned by Israel’s large, general purpose banks. Nine such mortgage banks operate today, only two of which are unaffiliated with a general-purpose bank. Besides the mortgage banks, two general purpose banks and several insurance companies are active in housing lending, but their market share does not exceed 2%-3%. The home financing market is highly concentrated; the three leading mortgage banks share 75% of the home market in terms of outstanding debt. (See Table 2.)

The structure of the market and much of its nature and operational aspects today stem from the way housing finance evolved in Israel. After years of providing direct financing by the government through its regular offices, the government decided to establish specialized finance functions that would handle the operation. These mortgage banks were later privatized but continued to operate as licensed agents for the government, extending and servicing government-owned loans, all under close regulatory supervision and for handsome fees.

These banks were supposed to act independently, as specialized institutions, consistent with their perception as administrative channels for the distribution of government funds and with the conviction that banking should be specialized. Eventually, most of these banks were merged into general purpose banking groups. In that environment, competition among banks and the familiar banking issue of risk management barely existed. The large general purpose banks ran housing finance operations through specialized subsidiaries, which operated via their parents’ branches nationwide.

Until the government mortgage system was reformed in 1990, funding had never been an effective constraint. The banks were responsible for origination and servicing, but there

| Table 2. Joint Balance of Mortgage Banks (1996 to 1997, Percent) |
|---------------------|-------|-------|
|                    | 1996  | 1997  |
| Assets:            |       |       |
| Cash               | 0.3%  | 0.3%  |
| Housing loans      | 78.1  | 79.7  |
| Construction loans | 5.5   | 4.9   |
| Other loans        | 16.1  | 15.2  |
| Liabilities        |       |       |
| Deposits from the public | 52.8 | 52.0  |
| Deposits from banks | 33.2  | 35.3  |
| Other              | 8.4   | 7.1   |
| Equity             | 5.7   | 5.6   |
was no risk involved as long as the banks carried out the government's guidelines.

Asset/liability management was not a fundamental concern to the banks because most of the banks' portfolios consisted of government-owned loans. The banks made virtually no decisions regarding loan terms and conditions; the government, which set interest rates and loan ceilings and duration, dictated these.

Following the 1990 reform, however, the banks were forced to locate funds to finance the origination of new loans. A significant element of the reform was the "unbinding" in 1989 of long-term investment funds (Provis- dent Funds) and insurance companies— which permitted them to deposit funds with mortgage banks.

Before the reform, these investors were obliged to deposit their funds with the government, although at seemingly attractive rates. The new arrangement proved beneficial to both parties, and the volume of outstanding mortgage debt increased dramatically over the years. With the rapid increase of portfolio loans and an inability to sell at least some of those loans on a secondary mortgage market—one does not yet exist in Israel—the banks had to develop ways by which to manage the various risks associated with a mortgage portfolio. (See Figure 3.)

THE FINANCIAL PRODUCT

A unique feature of the Israeli mortgage market is the linkage of the typical housing loan to the Consumer Price Index (CPI). Linkage to an anchor as means to overcome the problem of the unstable local currency is not a new idea: there was a preceding use of the U.S. dollar as an anchor to the mortgage system, but it collapsed in 1962, when the Israeli currency was devalued by 66% overnight.

All the agreements with the borrowers had to be revised then to help borrowers meet their monthly payments. Until 1979 loans were not linked, and unexpected surges of inflation could create considerable capital gains to borrowers. With the acceleration of Israel's rate of inflation in the 1970s, these capital gains materialized, and it became evident that there was a need to base loan repayment schedules on firmer financial grounds.

When the government decided to link the loans to the CPI in July 1979, the annual inflation rate was already 70%. The government's decision was mainly a matter of public policy, since at the time the government was the sole mortgage lender. As such, borrowers' inflationary capital gains were achieved at the expense of the taxpayers. Investors could protect their savings against unexpected inflationary capital losses and ensure their real return on investment by purchasing government bonds linked to CPI.

CPI-Linked Loans

A CPI-linked loan is a different instrument than a regular loan. Its amortization schedule is calculated as if it is a regular loan, but with its interest rate defined in real rather than nominal terms. Accordingly, the borrower agrees to pay the lender a specified yield immune to unexpected changes in the rate of inflation.

Thus, if the interest rate today is 7.00% and the inflation rate is expected to be 2.00% over the coming years, the implied annual real interest rate is 100 x (1.0700/1.0200-1) = 4.90%. This real interest rate is used for the calculation of the amortization schedule, and the result is a schedule that is identical to that of a regular loan bearing an interest rate of 4.90%.

The differences between indexed and non-indexed loans emerge with changes in CPI.
Whereas in the case of a regular loan, the original amortization schedule will stay unchanged, in the case of a linked loan the current payment amount and balance due will change every month, even after accounting for the monthly principal payment. The CPI-linked loan is actually a loan that is handled in a different currency, a 'notional' currency, whose exchange rate is defined monthly, with the official publication of the monthly CPI.

There are many features unique to CPI-linked loans. First, the monthly sum of principal repayment and interest payment is not constant over time, but moves in accordance with the CPI. It is thus a current real burden that is theoretically stable in terms of purchasing power, or rather, in terms of income, assuming the long-term linkage of income to the CPI.

This prevents the phenomenon of "front loading," typical of regular loans in an inflationary environment. Second, the balance due may actually increase during the first years of the loan, due to the linkage of the principal to CPI. This necessarily means that in an inflationary environment, the loan-to-value ratio (LTV) of a CPI-linked loan will decrease at a slower rate than the LTV of an unlinked loan.

A third distinguishing feature of the linked loan is that interest rate, monthly repayments and payments, and duration of the loan will be insensitive to changes in the expected rate of inflation at origination. Using the example above, an acceleration of the expected rate of inflation by three percentage points to 5%, which would have meant an increase of the nominal interest rate to 10.15% (keeping the real interest rate unchanged) and an increase of the monthly payment in the case of an unlinked loan, does not change the initial monthly payment and the duration in the case of a linked loan.

This aspect is especially important when considering an adjustable-rate loan. Since the volatility of the real interest rate is much lower than that of the nominal rate, the linked loan has an internal filter or "shock absorber" that will protect borrowers from sudden changes in monthly payments due to changes in the rate of inflation. This is a feature which is usually achieved in non-linked loans by adding "caps".

Regular, non-linked mortgage loans exist in Israel, but they are still rare. This can be explained by long periods of inflation in Israel’s past, which in 1984, for example, rocketed over 400%. In time, as alarming memories of rapid inflation fade away, the use of long-term, non-linked loans should increase.

Today, however, there is nearly no market for a fixed-rate regular loan, even for a relatively short period; and the typical loan is a daily calculated adjustable rate one. (See Figure 4.)

Housing Loan Characteristics

The most common housing loan is a 20-year, level-payment, fixed-rate loan. Longer terms are usually available, but with an adjustable-rate mechanism which allows for interest-rate resets at intervals of one, two-and-a-half or five years. Adjustable-rate loans are comparatively new—they were first introduced in 1989—and until mid-1996 have comprised only about 10% of the market volume.

A sharp increase of interest rates in 1996 and expectations that the high rates were temporary, caused a surge in the demand for adjustable-rate loans, and their share of total origination increased to about 50%.

Most housing loans in Israel carry a prepayment penalty. Originally, this penalty was set by the central bank to compensate the banks for the cost of reallocation of funds.

Figure 4. Inflation (CPI) Change Rate, 1986 to 1998
Accordingly, it was calculated as a fixed multiple of days of expected interest payments.

The reform of the capital markets in the late 1980s caused a significant drop in real interest rates, from 13% to roughly 7%. As a result, the mortgage banks suddenly faced the threat of massive prepayment by borrowers, who could realize huge capital gains at the expense of the banks by refinancing their loans at a lower interest rate.

The central bank decided to protect the lender banks against such a possibility by issuing a special regulation regarding the calculation of such a penalty. According to the new regulation, in case of a prepayment the borrower will pay the lender bank a penalty that will compensate the bank for most of the decline of future interest income due to a decrease of interest rate.

Restrain on Borrowing

Average loan size is rather small in Israel. This is because the free market is still young, and the habit of leveraged buying of homes is not yet customary in Israel. Until the beginning of the present decade, almost no funds were available to support private lending, and the central bank set a limit to the volume of loans to a single borrower. With no tax benefits attached, people have no tax incentive to borrow.

Thus, it is customary only for first-time buyers to rely on large mortgages, whereas people who are improving their living standards are usually more careful about the amount they are willing to borrow. This behavior will probably change over time, when people become more accustomed to leveraged home buying.

A foreign visitor might be surprised at the wide variety of loans available to the Israeli borrower. The reason for this is historic. When the government was the sole provider of housing credit, there was no aspect of asset/liability management to consider, and financial products were devised with only the borrower's needs in mind. New products were constrained only by the need to write computer programs to handle the servicing of these products.

Even today, with most of the loan portfolios financed by the banks, risk management consideration has not fully evolved, and the tendency still is to invent new financial products based on inordinate considerations of marketing. This manner of banking is bound to change with the growing awareness of financial risk management and the prospective development of a secondary mortgage market.

SOURCES OF FUNDS

To finance their lending, the mortgage banks need long-term funding and, based on the typical loan, a fixed real interest rate. The main sources of such funds in Israel have been institutional investors, especially provident funds and insurance companies.

Provident Funds

Provident funds are long-term investment funds, operated mainly by general purpose banks, through which households can enjoy certain tax benefits on their savings. These tax benefits are conditioned on a 15-year minimum duration of the account. Devised by the Treasury to promote long-term savings by households, provident funds are essentially mutual funds that face little redemption risk and so can invest in relatively illiquid assets.

Until 1987 these funds had to deposit their resources with the government, for an apparently preferred rate of return (usually 6% real rate of return). Following the reform of the capital markets, the government's financing needs decreased considerably, and these funds were allowed to turn to alternative investments, subject to several constraints.

Competition between the funds broadened to yield on investment, and the funds began to explore alternative investment opportunities. Because of the unique, long-term preferences of their depositors, the funds became a natural investor in mortgage banks. The vast scale and continued growth of these funds have enabled them to provide most of the cash needed by the mortgage banks during the last decade.

Pension Funds

Pension funds, also natural partners to mortgage banks because of their long-term investment horizon, have not yet been reformed and continue to hold their deposits with the government. One of the main obstacles to their reform, and thus to the release of huge reserves to be invested in the market, is the considerable actuarial deficit from which these pension funds suffer.

An agreement between the government and the pension funds that was signed in 1995 failed to seize the opportunity to further reform the capital markets, and instead concentrated on solving the actuarial deficit by allowing the funds to continue to make deposits with the government at a preferred rate. New pension funds, however, are allowed to invest their reserves in the free markets; but the small volumes of these latter funds make this decision irrelevant for the financing of mortgage banks in the near future.

The typical deposits with the mortgage banks are 15-years, fixed-rate, amortizing deposits. Shorter terms also exist but are not commonly exploited by the "term-hungry" institutional investors. Notably, public issuance of bonds is rare. Because the capital markets are highly concentrated, private placement to one of the few large institu-
Savings Accounts

Saving accounts are operated mainly by the general purpose banks. These accounts are open only to households and enjoy tax-free interest income. The accounts are mostly linked to the CPI, and the minimum term is two years.

These saving accounts started mostly as instruments for augmenting savings through fixed monthly contributions, but in the last few years have changed their nature and become mostly short-term oriented. Mortgage banks that operate independently have also started operating saving accounts in the last few years; but for fear of a mismatch between assets and liabilities, these accounts can only serve to finance short-term loans or adjustable-rate long-term loans.

The mortgage banks are approaching the point where their funding resources will be exhausted. The initial pace of new lending was made possible by the reform of the capital markets, which provided the banks with a large supply of previously unavailable long-term funds from provident funds.

However, the rapid growth of outstanding debt has not been matched by a concomitant growth of provident funds’ assets, and the banks are therefore likely to find themselves reliant on increasingly limited resources. Without additional reforms that will unbind new investors, particularly pension funds and insurance companies, the banks are expected to face a shortage of funds. With no secondary mortgage market yet in sight, this problem could be imminent.

LIENS AND COLLATERAL

A major obstacle to the development of mortgage lending in Israel has always been the inadequacy of property registration. Even today, a considerable portion of the housing stock is not formally registered, and changes of ownership are documented on various legal documents that are not registered in a central roll. This predicament creates a problem for the banks, preventing them in many cases from being able to perfect a lien. The banks must resort instead to contractual obligations.

Another difficulty arises from the government’s promotion for nearly universal homeownership, which necessarily includes prospective borrowers who are low income, immigrants with no credit record or young families without employment history. This leads to a relatively low credit profile of the average borrower in Israel, as compared to his counterpart in other developed countries.

Using Private Guarantors

Lending with a less-than-adequate lien registration system and to relatively risky borrowers poses significant hazards to the banks. The solution adopted by the banks in Israel has been the reliance upon private guarantors to enhance the collateral offered by the borrower. This solution was compatible with the special features of the Israeli market. It provided an alternative to liens in certain cases, and it enabled the banks to use a more liberal underwriting criteria towards prospective borrowers.

The banks relied on up to five personal guarantors, preferably close relatives of the borrower and often of a better socioeconomic standing. Each of the five guarantors was held responsible for the timely repayment of the entire loan. From the banks’ perspective, the system worked well. The default rate was kept relatively low, and the banks were usually able to recover the debts from the personal guarantors and did not have to deal with foreclosures.

However, public pressure was put on the legislature to limit the ability of banks to move against the guarantors, and in 1992 the law was amended to significantly limit the ability of the banks to rely on personal guarantors. This development revived the need for proper registration of ownership and liens and for rigorous standards when appraising credit risk.

Construction Financing Problem

An additional obstacle to Israeli mortgage lending is the tendency of borrowers to require financing at early stages of home building. Unlike systems elsewhere, where the sale of a new house takes place only after construction is completed, contractors in Israel often sell houses before or during construction. This habit creates a situation in which mortgage loans are used to finance construction, and the collateral in this case is usually performance guarantees issued by a different bank, usually a commercial bank that does the construction lending.

This fusion of different genres of credit risks could be overlooked in a system that relied more on private guarantors than on liens, but with limitations on resort to guarantors now governing them, mortgage banks must question their involvement with a complicated mixture of mortgage loans and construction loans.

Importantly, LTV ratios in Israel are low compared to most western countries. With no tax benefits attached to housing loans, only borrowers with a lack of their own resources turn to high LTV financing. Since the government assists these borrowers, higher LTV loans usually reflect a combined government/bank loan. In these cases, the rights of the bank and the government are pari passu.

PROSPECTS FOR A SECONDARY MORTGAGE MARKET

The evolution of the secondary mortgage market in the U.S. and discussions about
spreading the idea to developing markets did not escape the main players in the capital markets in Israel. Interest was also expressed by government officials. Several attempts were made to study the American example, the possibility of implementing this example in the Israeli market and the potential benefit of such a market.

Low-level study groups that were appointed as a result of local initiatives taken by government officials were already operating in 1991, trying to assess the benefit of promoting the establishment of a secondary mortgage market in Israel. At the time, funding problems still seemed to be in the distant future, with lending still leaning heavily on government loans and with provident funds still showing seemingly unlimited capacity to finance the mortgage banks.

Nevertheless, the government made a decision in 1992 to establish a secondary mortgage market in Israel. This market was to replace the existing system of housing finance, demanding direct government intervention, with a new, market-based system.

Decision Not Implemented

For various reasons, the decision taken by the government in 1992 was not carried out. Certain steps were taken, among them an initiative to replace the government loan to eligible borrowers with a government guaranty of a loan made by the bank. As a pilot to this initiative, there was an effort, which failed, to sell an existing portfolio of government loans.

In the meantime a crisis developed in 1996 in the capital markets, and a new government committee was created to suggest reforms for the capital markets. Having only limited time to design its recommendations and feeling that the question of establishing a secondary mortgage market deserved a lengthier probe, the committee decided to establish a subcommittee that would concentrate on that question.

There were two issues before the subcommittee: first, to determine to what extent government intervention is needed in order to establish a secondary market in Israel; and second, to identify legal and tax issues that currently prevent the development of a private secondary market.

The subcommittee presented its recommendations to the government in 1998. Regarding the first issue, it suggested that the government refrain from intervening directly in the market, for example, through the establishment of agencies like the American Fannie Mae or Freddie Mac, or by creating a national mortgage insurance entity. Regarding the second issue, the subcommittee pointed out a list of legal and tax issues that the government had to deal with in order to enable the market to function. Most of these issues were handled recently.

Barriers to Establishing a Market

There are several obstacles in the path of developing a secondary mortgage market in Israel. First, there is the lack of clarity as to whether it is possible, under the existing law, to transfer the lien to the investor. Without the ability to transfer the lien, the securitization of mortgage loans will necessitate some new legal solution.

Second, there is the question of the future relationship between potential investors and the government. The existing contract between the government and the mortgage banks specifies that loans to eligible borrowers are to be jointly originated and backed pari passu against the collateral. This compulsory bond is a major obstacle to the securitization of the bank’s loan, since the investors’ rights are not independent of the government, and future moves by the government can affect the position of the investor.

Third, the lack of a well-advanced system of registration of land ownership and the prevailing habit of purchasing homes before their construction is complete—including making loans to households which are actually used to finance construction—will necessitate some adaptations on both sides.

Fourth, the lack of standardization in contracts and financial products—the variety of types of loans and the habit of packing together different kinds of financial products in one loan—might prove a hindrance to the future market.

In spite of the difficulties, secondary market transactions have been signed over the years. Only one of them, made in 1989, involved a public issuance of a mortgage-backed security. All the rest were done later and were actually the sale of part of the rights of the banks to a defined portfolio of loans.

These transactions were private, involving in each case one mortgage bank and one investor. Typically, the sellers were independent small mortgage banks that sought to improve their capital adequacy, and the buyers were provident funds. The fact that the circle of investors is so small and that no public issuing of considerable scale has occurred means that the Israeli capital markets have not yet been exposed to the idea of a secondary mortgage market.