International Union for Housing Finance

IUHF - A global organisation meeting your interests in housing finance

NEWSLETTER *August 2006*

Don't Miss Out on Vancouver

By Adrian Coles, Secretary General, International Union for Housing Finance

Welcome to the latest edition of the IUHF *Newsletter*. In this edition we have articles on the success of the East Caribbean Home Mortgage Bank, a view on the Indian housing market, the formation of the new European Covered Bond Council, a review of the European Mortgage Federation's research into the different degrees of interest rate variability on mortgages across Europe, a review of the OECD research on house price bubbles, some thoughts on the development of the European Single Market and a view on the work of the European Parliament and its attempt to develop a "charter" for housing. The IUHF is extremely grateful to the all of the contributors to this Newsletter.

This will be the final *Newsletter* that we publish before the World Congress of the Union being held in Vancouver between 19 and 22 September. The number of registrations has been extremely encouraging. There are, however, still places available. Full details can be found at http://congress.housingfinance.org Here you can look at a detailed timetable and agenda for the event, a list of speakers, the sponsorship opportunities and review the opportunities for extending your stay in Vancouver. The World Congress promises to be an outstanding event. The website offers the facility to book online – don't leave it too late! (Members of the Union should also note that the General Council meeting of all members will take place in Vancouver on 21 September.)

ECHMB – 10 Years of Commercial Operations: A Regional Success Story

This article was prepared by the staff of ECHMB

On 22 April 2006 the Eastern Caribbean Home Mortgage Bank (ECHMB) reached a milestone, attaining ten years of commercial operations. At the start of its operations in April 1996, ECHMB presented to the mortgage industry an alternative financial model for funding mortgages. Ten years later ECHMB has emerged as a successful corporation with total assets amounting to over $130 million, funded by debt raised in the capital market amounting to $112 million, and equity capital of $15 million.

ECHMB began its life as a corporation with shareholder capital of EC$10 million, with the Eastern Caribbean Central Bank (ECCB) as its biggest shareholder. Today, ECHMB has grown from a pioneering institution into a formidable business in the secondary mortgage market.

During those years ECHMB has been true to the mandate conferred on it by the Monetary Council of ECCB to develop the money and capital market and to provide funding for residential mortgages, throughout its participating member countries namely, Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia and St. Vincent and the Grenadines.

ECHMB is also mandated to ensure that the citizens of the Eastern Caribbean (EC) have access to quality

Sir K Dwight Venner, unveiling the plaque, signalling the start of ECHMB's commercial operations in April 1996.

Participants attending Home Ownership Day – Antigua and Barbuda in June 2000.

and affordable housing. In that regard, ECHMB has institutionalised a Public Awareness Programme – **"Home Ownership Day" Event**, designed to provide information to homeowners on pertinent issues related to the proper construction and maintenance of housing, as well as the responsibilities of personal financial management and home ownership. The Event provides a forum where stakeholders of the mortgage industry, including prospective homeowners, primary lenders, architect/planners, contractors, lawyers and the public at large, come together to discuss a wide range of topics such as: -

- Obtaining Credit and Managing Mortgage Obligations;
- Planning of Residential Home;
- The OECS Building Code and Guidelines;
- Legal Requirements for Mortgages;
- Post Construction Maintenance to Sustain the Value of Homes; and
- Alternative Investment opportunities in the ECCU.

The Home Ownership Day Event has also focused on enabling customers to become more astute in borrowing by instilling in them the virtues of financial management to improve their creditworthiness. The Event has also provided a forum for senior policy makers from Member States to pronounce on significant policy initiatives, geared in particular to enforcing of Building Codes. To date, more than fifteen hundred participants have directly benefited from the Seminars as well as thousands more who benefited indirectly through television rebroadcast of the Events by the official media network in the country where the Events were mounted.

The business principle under which ECHMB operates includes the purchasing of high quality mortgages from primary lenders with the aim of repackaging those mortgages for sale to investors, through mortgage-backed-securities. An essential prerequisite for successful implementation of mortgage-backed-securities or securitisation is that the mortgages that are purchased must be of very high quality. Equally important is the need for the mortgages to be standardized. The evidence from the market indicate that investors, though they are generally enthusiastic about real estate, are equally concerned that the company issuing the securities are equipped with the capabilities in mortgage underwriting and standard practices with regard to processing mortgages and policies governing servicing and transfer of mortgages

Participants attending a Mortgage Underwriting Seminar in Grenada, April 2003.

that form part of a securitised pool. The timely reporting on the mortgages is also very crucial.

Over the 10 years ECHMB has been undertaking a Programme to foster International Best Practice and Standards among lending institutions through its accredited **Mortgage Underwriting Seminars**. The Seminars are conducted with the support of Canada Mortgage and Housing Corporation (CMHC) and the Real Estate Institute of Canada (REIC), along with local and regional resource persons. The three part Module Seminar covers country-specific issues pertaining to property valuation, legal requirements, building controls and structural integrity of buildings, mortgage origination, underwriting, default management, credit appraisal and risk management specific to the mortgage industry and ethics. Since the programme was institutionalized, so far about 50 Managers from lending institutions have graduated with the professional Accreditation **"Certified Residential Underwriter"**.

Over the 10 years ECHMB has demonstrated its ability to consistently improve on its financial performance. As at the year ended 31 March 2006 ECHMB's shareholders' Equity reached EC$17.0 million. Earnings per share moved from EC$2.21 in 1997/98 to EC$25.0 in 2005/06. In addition, ECHMB has been able to maintain a track record of paying annual dividend to its shareholders beginning from its third year in business. In the past six years it has paid annually a dividend amounting to $10.00 per $100.00 share. During the period under review, the Bank paid out dividends amounting to EC$6.75 million to its shareholders. This achievement belies the tenure of the institution as a business entity, as well as the challenging conditions under which the Bank has operated. These conditions included a high liquidity situation in the financial system, and constant erosion on mortgage yield as a result of lowering of interest rates on mortgages. Furthermore, the players in the primary mortgage market have shown a preference to originate mortgages for their own portfolio.

Over the ten years, ECHMB has been able to efficiently manage the risks associated with its business operations and at the same time lower its cost of borrowing on the capital market. These initiatives enabled the Bank to reduce the benchmark lending rate for mortgages originated by primary lenders using its funding facility. By so doing, ECHMB was able to pass on the benefits of lower interest rates to citizens of the Currency Union.

Ten years after the launching of the project, the discerning observers of ECHMB's progress are measuring its success by increased shareholder value and the size of its assets base in mortgages. But it is at the qualitative level that ECHMB's operations become most visible. ECHMB's reputation has been enhanced by the activities

Sir Bernard J Sebastian, CEO, Easter Caribbean Home Mortgage Bank

in consumer education and the international best practices in mortgage underwriting, transferred to lending institutions. In addition, perhaps better than any data, the success of ECHMB is attested for by the enthusiasm demonstrated by eligible shareholders and non-shareholders for the purchase of ECHMB shares that were originally held by the World Bank/International Finance Corporation (IFC). ECHMB shares with an original par value of $100.00 were sold by IFC in February 2006 at a price of $160.00.

According to Mr. St Bernard J Sebastian, ECHMB's Chief Executive Officer ***"the success and financial performance of the Bank can be attributed to its efficiency in raising its resources through Corporate Bonds in a fledging capital market and at the same time being able to purchase quality mortgages at competitive rates."***

ECHMB bonds have become a preferred investment instrument for institutional investors, as well as for individuals. These bonds generally offer investors a higher yield than what currently obtains on a fixed deposit at a commercial bank, in addition to being free from income tax. Besides they provide investors with a sound and stable alternative to other traditional investments.

For additional information about ECHMB or to inquire about its Bond Issues and Mortgage Funding Facility, please contact:

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Building a sustainable organizational capability to enable home ownership among lower and lower middle income segments in India

By Kapil Wadhawan, Managing Director, Dewan Housing Finance Corporation Ltd.

Kapil Wadhawan

DHFL (Dewan Housing Finance Corporation Limited) was founded 22 years ago (April, 1984) with the core purpose of enabling access to affordable housing finance to individuals in the low income and lower middle income group. In many ways, India is no different from many fast developing economies when it comes to issues related to housing, although the problem gets more complex when one considers the diverse nature of India's population and its geographical spread.

Housing inadequacies in India have both quantitative and qualitative aspects - as per government agencies, there are 179 million buildings in India which are used as residences. As per India's population at the time of census 2001, this roughly amounts to 6 persons per house. About 40 per cent of all households in India live in single room houses, while close to 50 per cent of all households do not live in permanent structures. Non-permanent households constitute nearly 59 per cent of all rural households. 97 per cent of rural households live in their own dwelling unit, while only 65 per cent of urban households own the house that they live in.

The problem of housing in India has tended to worsen over the years due to the following factors:

- Rapid increase in population
- Fast rate of urbanization
- Proportionately inadequate addition to housing stock

Nearly 36 per cent of India's population is likely to be urbanized by 2025, increasing the demand for supply of affordable housing stock. The current housing shortage in urban India alone is to the tune of 23 million dwelling units, while the problem in rural India is supply of quality housing stock. Both are important issues that require players from the government and regulatory agencies to come together with participants from the private sector to promote home ownership and growth of good quality yet affordable housing stock.

DHFL is one of the few companies in India which has a focused approach to financing home purchases. While the housing inadequacy described above affects a large section of India's population, the problem faced by the low income and lower middle income (LMI) household merits greater attention. Lower and lower middle income households are largely perceived to be outside the informal economy and their income levels are above the threshold levels set by micro-credit institutions, making them a fragmented segment that is neither served by formal credit institutions nor by micro-credit institutions at the lower level. Consequently, individuals from moderate income households rely on informal sources of credit from friends, family and money lenders to fulfill their financing needs. This form of financing is both insufficient to fulfill the desired outcome and costly, making it an unattractive proposition for the LMI individual. Coupled with the lack of adequate supply of housing stock, the lower middle income households find it very difficult to realize their dream of owning a home and living in them. For this segment house buying is about the most important decision in their lives. While interest rates do matter they do not appear to affect the decision to buy as much as they do so for investors in housing stock. Buying real estate and buying a home is not the same. Most home buyers in India do not buy a house from an investment viewpoint - they do so for shelter-security. This is the most important aspect of the home buying decision process of an ordinary Indian household. The rates of interest and other attendant costs do affect the LMI home buyers due their tight capital budgets and limited income flows. In fact, apart from interest rates there are other transaction costs which affect the LMI segment significantly. Costs such as stamp duty and registration charges, insurance, and those associated with lack of building codes which are reliable, add significantly to the acquisition price of homes. Of course, there is also an access cost that this segment is forced to bear as it is not the preferred segment of most lenders in the housing finance market.

Thus, our focus on lower and lower middle income (LMI) households as a target segment makes it very exclusive in terms of a corporate endeavor. All the efforts of the company and its stakeholders have been dovetailed to service the housing needs of this segment. The DHFL agenda over the years has been to further develop the different facets of its corporate personality which amplifies its focus and approach to the LMI segment.

There are two key aspects of DHFL which guide its actions across functions. One is the engaging nature of the relationship it endeavors to establish with its customers and the other is the empathy that it brings into such relationships. The main challenge for the organization has been to institutionalize these attributes. An engaging nature of the relationship with any customer places an enormous responsibility on the company and its organization in terms of functioning. While we have realized the need to develop a relationship of engagement with the customer quite some time back we have only now been able to identify the various building blocks of the organization which would make this a reality.

The foremost factor that affects the organization's response to the customer is the way each member of the organization perceives the centrality of the customer and her need to the organization's existence. While the phrase "Customer is King" is as clichéd as any phrase can get, at DHFL there is an organization-wide movement to ensure the centrality of the customer. Every member of the staff at the branch is expected to adopt a select number of customers and know every detail of the customer though regular and intense interaction. The customer has always the benefit of knowing at least one person at the branch at a fairly personal level. For our customers this is a treasured relationship. For the organization and its members this is a necessary aspect of relating to the customer. It is our strong belief, and a non-negotiable one, that every customer of DHFL would experience the same kind of engagement with the organization. DHFL perceives itself as a companion in the customer's peaceful journey towards home ownership.

It is this aspect of our engagement with the customer that has prompted us to bundle insurance protection plans with the housing loan. A customer of DHFL is covered against loss of employment (for a limited period), injuries due to accidents, threat to the home from fire and natural calamities, as well as against loss of life of the main borrower. Going forward, we would like to offer a medical insurance plan that prepares our customers to meet medical emergencies. The need for making available mortgage insurance to the LMI segment is becoming increasingly urgent. Apart from enhancing the interest in lending to this segment, it would reduce the cost of home acquisition for them considerably.

While our focus on the under-served markets in India has helped us achieve considerable customer capital, as a business enterprise our consistent profit growth over the last 5 years (Compounded Annual Growth Rate of 25%) demonstrates our ability to build a sustainable business model in the housing finance sector.

More information at
www.dhfl.com

The European Covered Bond Council

This article was prepared by officers of the European Covered Bond Council

The European covered bond market is one of the most dynamic segments of the European capital market and as such, a main driver of the integration of European financial markets as outlined in the European Commission's Financial Services Action Plan (FSAP). The internationalisation of formerly domestic covered bond markets began 10 years ago with the introduction of a new benchmark product attracting international institutional investors and providing the necessary market liquidity.

As a consequence, many European countries have introduced new covered bond legislation or have updated existing rules to be a part of this development and to also respond to the considerable growth of mortgage lending activities in the European Union. With a volume outstanding at the end of 2005 of EUR1.77 trillion from more than 20 countries, covered bonds play an important role in the financial system and contribute not only to the efficient allocation of capital, but also ultimately to economic growth.

ECBC

European Covered Bond Council

The Covered Bond Voice of the European Mortgage Federation

The overwhelming success of the covered bond led the European Mortgage Federation to launch the European Covered Bond Council (ECBC) in late 2004. The ECBC was set up amid expectations it would attract 30 or 40 members after a year. However, by the end of 2005 the ECBC had attracted over 70 members and, today comprises close to 80 members – ranging from covered bond issuers, investment banks, research analysts, rating agencies and trading platforms – accounting for almost 85% of all covered bond issuers. The ECBC's role is to highlight the position of covered bonds at European level and operate as a think-tank, as well as a lobbying and networking platform for covered bond market participants.

ECBC Bodies

All ECBC members come together twice a year in the **Plenary** meeting, where people discuss the latest market and regulatory developments and suggest topics that might be dealt with in specific working groups. The February 2006 Plenary meeting attracted numerous participants and the ECBC was honoured to welcome regulatory and supervisory authority representatives from Germany's BaFIN, the Italian Ministry of Finance, the Dutch Central Bank, the Dutch Ministry of Finance and the UK's FSA. The FSA, which has recently been working towards the introduction of appropriate rules for the regulation of the UK covered bond market, took the opportunity of the meeting to announce their intention to consult on whether or not to implement Article 22(4) of the EU UCITS directive. The next ECBC Plenary meeting will take place on 6 September 2006 in Madrid.

The **Steering Committee** meets four times a year to discuss the day-to-day business activities of the Council. It prepares strategy-related decisions and coordinates the agenda of the various working groups. The Steering Committee is headed by the ECBC Chairman, who is the first representative of the ECBC in all operational matters. In addition, the ECBC discusses more technical issues within the realms of its various **working groups**.

ECBC Working Groups

Since its inception in November 2004, the ECBC has created no less than six working groups, which meet up on a case-by-case basis with frequency depending on the subject matter. The **Capital Adequacy Working Group** has followed the debate on the Capital Requirements Directive (CRD) and has been successfully lobbying at EU level to obtain a special treatment for covered bonds. In this respect, the ECBC looked particularly at which assets should be eligible for covered bond collateral, and related to that, the credit quality of the underlying assets. The ECBC was instrumental in reducing the question of the supervisory Loss Given Default (LGD) level from an initial level of 20% to 11.25%. Currently, the group is responsible for monitoring the transposition of CRD at national level.

The **Rating Agencies Working Group** examines rating approaches applied by rating agencies for covered bonds and publishes position papers when necessary. This working group will soon come together to analyse and provide comments on Fitch's new proposed covered bond methodology. The **Statistics Working Group** is responsible for collecting and publishing complete and up-to-date information on issuing activities and volume outstanding of covered bonds in the various European market segments. The **Technical Working Group** tackles specific issues such as the use and treatment of derivatives in the cover pool, bankruptcy remoteness and collateral. This group is currently analysing all the existing covered bond frameworks in Europe, comparing and contrasting them with the aim of delineating common standards for the covered bond asset class.

The **Trading Standards Working Group** will be discussing topics such as minimum standards for market making for Jumbo's, conventions on trading standards and the market-making process. Its job is to ensure liquidity and maintaining the market making commitment. The decision to press ahead with this working group was catalysed after the downfall of Allgemeine Hypothekenbank Rheinboden and a temporary loss of market making in its bonds. Last but not least, the Working Group on the *European Covered Bond Fact Book* will be responsible for preparing a fact book on European covered bonds which will cover market developments, legislative frameworks in different countries and statistics. The *ECBC European Covered Bond Factbook 2006* is designed as a comprehensive source of information on the different national covered bond markets and their legal basis and will be published in September 2006, coinciding with the ECBC Plenary meeting and the Euromoney/ECBC Covered Bond Congress. The book replaces a former publication of the European Mortgage Federation entitled *Mortgage Banks and the Mortgage Bond in Europe* which was published in November 2003.

Euromoney/ECBC Covered Bond Congress

In order to help realise the ECBC's objective of highlighting the position of covered bonds at the European level, it was agreed that the first Euromoney/ECBC Covered Bond Congress will be held alongside the next ECBC Plenary meeting in Madrid on 7 September 2006. The conference programme is currently work in progress but has already attracted some high level speakers, with Mr Joaquin Almunia - the European Commissioner for Economic & Monetary Affairs - confirmed as the ECBC keynote speaker. With the aim of becoming the covered bond industry's premier annual event, the Congress will not only strengthen the ECBC's position as the authoritative voice on covered bonds but also increase its capacity to operate as a think-tank and a networking platform for covered bond market participants.

ECBC – looking back

In the 18 months, the stage has been set: the ECBC has laid down its objectives, drawn up an agenda, created working groups and has already been highly productive on a number of issues. Meanwhile, membership of the ECBC continues to increase. For the coming months, the agenda is already booked with many activities. Its objective is now to press ahead in its work with a view of further strengthening the ECBC as a voice for the European covered bond industry and beyond.

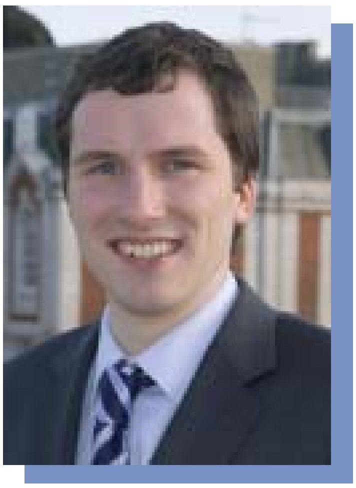
For more information on the activities of the ECBC and its members, please refer to our website http://ecbc.hypo.org.

Mortgage Interest Rates in Europe

By Andrew Gall, Business Economist, Building Societies Association (UK)

The European Mortgage Federation (EMF) has recently published a study into the degree of variability of mortgage interest rates in Europe. This research is available on the EMF website at http://www.hypo.org/Content/Default.asp?PageID=159

The study found that while the majority of mortgage lending in the EU is at rates that are fixed for some period of time, there are wide discrepancies between the different countries. The research notes that the prevalent type of mortgage interest rate within a country impacts importantly on the transmission mechanism of monetary policy within different EU states. It also suggests that there is evidence that some EU mortgage markets are incomplete, but that further integration could fill these product gaps.

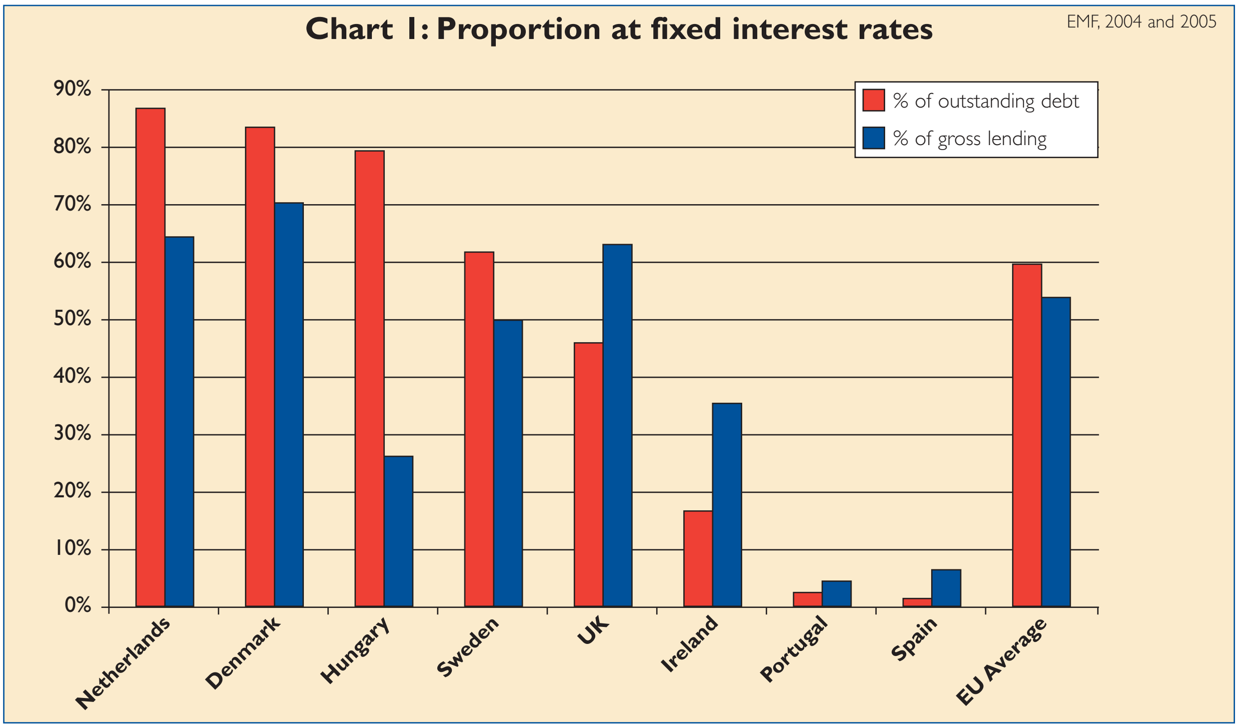


Andrew Gall.

The research looks at the split between different types of mortgage in terms of the stock of outstanding mortgage debt, and also in terms of the amount of gross lending in a particular year. The proportional split in the former abstracts from the volatility often seen in the latter.

The EMF analysis found that around 60% of the outstanding mortgage debt in the EU is subject to fixed interest rates. Germany, France, Denmark and the Netherlands are among the countries that typically have fixed rate loans. Italy, Spain, Portugal, Ireland and the UK had particularly high proportions of variable rate mortgages within the stock of debt.

Whilst in aggregate, the flow of gross lending in the EU was predominantly at fixed rates, at about 53%, there is wide variety when individual countries are examined. This proportion tends to be more volatile and shows a greater degree of



cyclicality than the split in the outstanding debt. Market conditions can change rapidly, altering the most prevalent form of mortgage lending in a country.

This is highlighted by the structure of interest rates in gross mortgage lending. Chart 1 shows (for countries where the data was available) how the split between different interest rates within the stock of lending and the gross lending within a year can be substantially different. For example, in the UK fixed rates made up 63% of gross lending in 2005, despite the UK favouring variable rate loans historically. This was because the flattening of the yield curve resulted in fixed rate mortgages becoming more attractive. In Hungary, where almost 80% of the stock of mortgages is financed with fixed rate loans, nearly three quarters of the gross lending in 2005 was at variable rates due to variable rate foreign currency mortgages that are newly popular following a change in the subsidy system in 2003.

Several factors affect the extent to which variable or fixed mortgage interest rates prevail. Firstly, cultural differences such as historical precedents, borrowers' preferences and the frequency of moving house influence the attractiveness of different types of mortgage. This will be particularly observable in the split based on the outstanding mortgage stock, as this is less cyclical. UK borrowers may tend to opt for variable rate loans because of the importance attached to the initial monthly repayments or because of a greater propensity to move and upgrade houses than in other countries. As mentioned above, the shape of the yield curve influences the attractiveness of long term fixed interest rate mortgages. Regulatory constraints on early repayment can restrict the use of variable rates. This is found to be the case in Italy and Germany. The way in which mortgage lending is funded also impacts the type of mortgage interest rate offered. Variable rates tend to prevail where retail funding is more dominant. Long term fixes tend to be more common where alternatives to retail funding, such as covered bonds, are more common. Germany and Denmark, with the largest mortgage bond markets in Europe, are examples where fixed rates prevail. The instigation of interest rate setting by the European Central Bank over many EU countries has also had an effect on the mortgages on offer in those nations. In Italy, for example, fixed rates have become more widely available as the interest rate has stabilised.

The structure of mortgage interest rates within a country has significant implications for how central bank interest rate changes feed through into the general economy. In particular, household disposable income would be affected by changes in the monthly interest payment on mortgage debt due to changes in the short term interest rate. The greater the proportion of variable rate mortgages in a country, the more sensitive the economy is likely to be to changes in the interest rate. This is also contingent on the level of debt, as the more mortgage debt held, the greater the impact of a given change in interest rate. The extra sensitivity may enable a faster response to a change in the interest rate, but it could also contribute to greater macroeconomic volatility.

This presents a particular problem for the European Central Bank in setting a single interest rate for countries with diverse mortgage interest rate structures and differing levels of indebtedness. Indeed, interest rates set for the whole Eurozone are lower than they would have otherwise been for certain member states, such as Ireland and Spain, and are likely to have fuelled the house price booms in these countries.

The EMF research also states that the lack of availability of certain types of mortgages in some countries limits consumer choice, preventing home buyers from matching their risk preferences to their financial planning requirements. The EMF suggests that further mortgage market integration could benefit consumers by filling the product gaps in some national markets.

House price peaks around the world

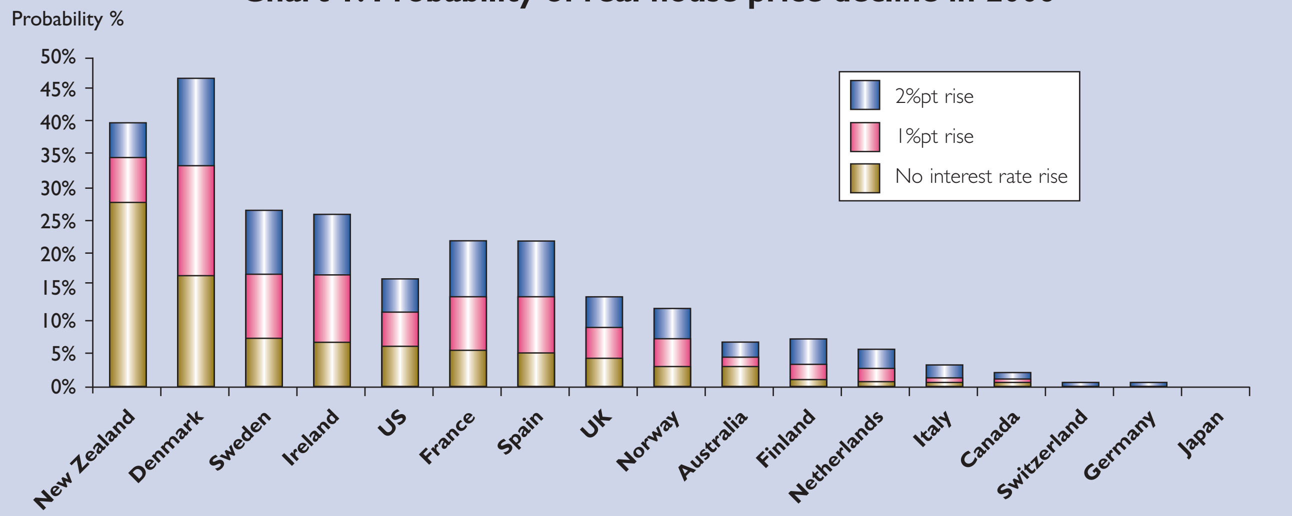
By Andrew Gall, Business Economist, Building Societies Association (UK)

In the past three decades real house prices in many developed countries have been on an upward trend, despite wide fluctuations around the long run growth rate. In many countries, the house price growth in the current cycle appears to be larger in amplitude and longer in duration than previous deviations from the long run trend. The upswing has lasted almost twice as long as prior periods of rising prices, and the real price gains have been almost double the size. Furthermore, the current house price upturn seems to have become unusually dislocated from the business cycle, a pattern it previously followed relatively closely.

Accommodative monetary policy across the world in response to the 2000-2001 downturn could have buoyed the market, and low long term bond yields and credit liberalisation have made it easier to secure finance for house purchase. History implies that house prices will correct, reverting to something nearer trend growth rate. The OECD has researched[1] how likely it is that real house prices will fall across several OECD countries this year.

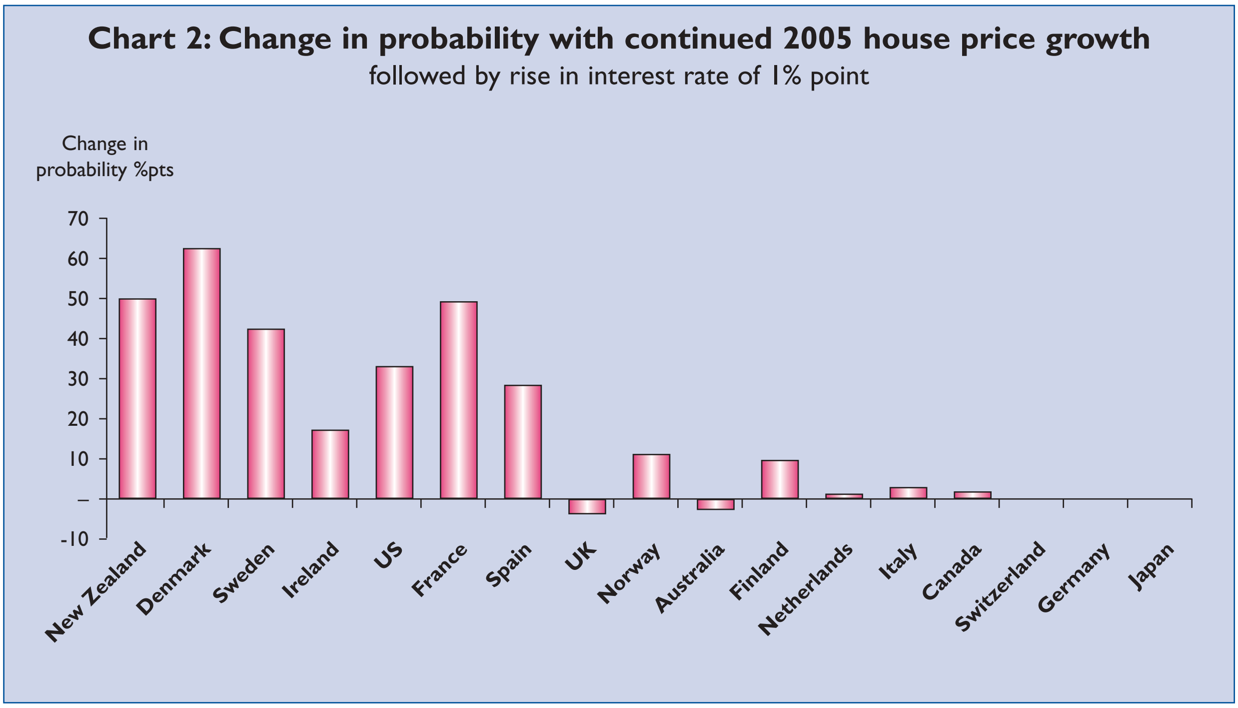
Previous OECD research[2] indicated that the majority of house prices are generally supported by underlying fundamentals and country specific constraints on housing supply. However, whether houses are fairly valued or not depends crucially on interest rates remaining at low levels. If interest rates were to increase, house prices would come under downward pressure as the low borrowing costs of the past decade begin to rise. The OECD therefore reappraises the likelihood of real house prices falling following increases in the interest rate.

Chart 1: Probability of real house price decline in 2006



[1] "Are house prices nearing a peak? A probit analysis for 17 OECD countries." OECD, June 2006

[2] "Recent house price developments: the role of fundamentals" OECD, January 2006



The research finds that if interest rates stay at the end of 2005 levels, the probability of house prices peaking in 2006 was less than 25% in all the OECD countries except for New Zealand (See Chart 1). However, many interest rates around the world have already risen from their levels at the end of 2005. If interest rates were to rise by 1 percentage point in 2006, the likelihood of house prices peaking would rise significantly in most countries, with the likelihood of prices falling in Denmark rising to nearly 35%. A further percentage point increase in the interest rate would further raise the probability of a peak occurring in all countries. House prices vary in how sensitive they are to changes in interest rates across different countries. This will depend in part on the prevalent type of interest rate on mortgage lending in each country, as discussed in the previous article in this issue.

Chart 2 shows how the likelihood of prices falling would change if real house prices continued to grow in 2006 at the same rate at which they grew in 2005. House prices in most OECD countries would be at considerably greater risk of falling, including some countries found to be at relatively low risk before the extra year's price inflation. For example, in France the probability of house prices falling would rise by almost 50 percentage points to over 60%. In contrast, the likelihood of house prices falling in the UK and Australia would reduce if 2005's rate of house price growth continued for a further year. This is because house price growth in these markets had already started to slow in 2005.

Country by country analysis

The research adapts the general model by adding extra variables for each country that better explain that nation's historical house price movements. The variety of variables used for different countries is an indication of the fundamental differences between various housing markets around the world. For example, the inflation rate improved the model when applied to the US housing market but the unemployment rate improved the application of the model to the Italian housing market.

Including country specific variables to improve the predictive power of the model polarises the results, suggesting a significant probability of house prices falling in some countries and a very low probability in others. Before any increase in interest rates, there is found to be a substantial chance of house prices peaking in 2006 in the US, New Zealand and France. With a 1% point rise in interest rates Denmark and Ireland would also appear to be close to peaking. The models for other individual countries suggest little or no chance of real house prices falling in 2006.

Taking the models together, the countries that are at risk of nearing a peak in real house prices if interest rates significantly increase from the levels at the end of 2005 are the United States, France, Denmark, Ireland, New Zealand, Spain and Sweden. However, care needs to be taken in interpreting these results. They use historical house price movements to predict the presence of current and future peaks. There have been structural changes, such as the liberalisation of credit markets that facilitate more flexible financing of house purchase, that may mean housing markets behave differently to how they did in the past. Even so, it is questionable whether such factors have changed enough to support the current prices. It is therefore likely that there will be some reversion towards the house prices implied by the long run trend.

Any adjustment in real house prices is likely to be less dramatic and disruptive than in previous episodes of contraction, but may depress economic activity for a longer period. Nominal house prices do not typically fall, as existing homeowners simply withdraw from the market instead of suffering a capital loss and house builders postpone new projects. With stagnant nominal prices, any decline in real house prices will have to come about through the effects of inflation. However, with low levels of consumer price inflation in most countries, the adjustment in real house prices is likely to be protracted. Without an external shock to cause a more radical correction, slowly adjusting real house prices could then have a prolonged impact on the general economy via depressed consumer spending.

More at **http://www.olis.oecd.org/olis/2006doc.nsf/linkto/ECO-WKP(2006)16**

What Next for European Mortgage Lenders?

By John Smullen, University of Greenwich Business School and Keith MacDonald, Partner and Olivia Lyne, Consultant, Capco

The mortgage market in Europe has shown very little product innovation over the last few years, despite (or perhaps because of) the surge in house prices in most countries. Current account mortgages were seen as a big step forward but have had limited effect on traditional lending. The arrival of the Euro has had some impact on cross-border lending in mainland Europe, but again has produced no significant change to domestic mortgage markets. The increase in cross-border mergers and acquisitions could bring further shifts, perhaps in mortgage processing utilities, but from the consumer's perspective there seems little movement. The majority of consumers across Europe continue to buy retail financial services from domestic suppliers, mortgages being no exception.

Why therefore is the cross border European mortgage market so stagnant? And what will, or can, the mortgage lenders do to change things? Do they want change anyway? And why is the European Commission pushing so hard for cross-border mortgage market harmonisation?

The EU Directive

The European Commission (EC) has identified the retail mortgage market as a priority area with scope for further integration. In July 2005, the EC published a Green Paper on 'Mortgage Credit in the EU', launching stakeholder consultation on the merits of Commission intervention in the EU residential mortgage markets and the associated costs and benefits of this integration. The EC is pushing for a more efficient, competitive and integrated retail mortgage market which could contribute to the growth of the EU economy. This paper will be followed by a White Paper (originally to be published mid 2006, but now postponed to 2007) which will assess stakeholder responses and outline the EC's recommendations and initiatives for further integration. The stated intention to issue a White Paper by the EC is regarded by some lenders as a clear intention to proceed further with integration.

The EU hypothesis is fairly simple. Integration of the European mortgage market and the introduction of the 'euro mortgage', a cross border lending product, is expected to benefit both the consumer and lenders. Consumers will have access to a wider product range and lower prices which would have a positive impact on housing affordability. "An efficient single market could mean cheaper and better loans for all Europeans, whether or not they obtain their mortgage abroad" (Charlie McCreevy, EU Single Market Commissioner). Lenders would benefit from reduced market risk from a more diversified mortgage portfolio, improved efficiency due to increased competition and economies of scale, and reduced funding costs for mortgages from a deeper more liquid secondary market in mortgage debt.

However, despite these recognised benefits the industry has given it a mixed reception, not only competitive defensiveness, but also recognising the structural and behavioural differences between the markets. In particular the UK's Council of Mortgage Lenders, have been particularly outspoken responding that there is "little obvious benefit for UK lenders or consumers from the proposals given that the UK already has a highly competitive and well regulated mortgage market…. there is a risk that

European-led changes to the FSA mortgage regime could simply increase costs without providing corresponding benefits." (Michael Coogan, Director General, Council of Mortgage Lenders). London Economics estimate the cost of integration at €2.5bn a year equivalent to 0.02% of GDP. These costs are largely associated with complying with new regulations, such as staff training, legislative process and technology change.

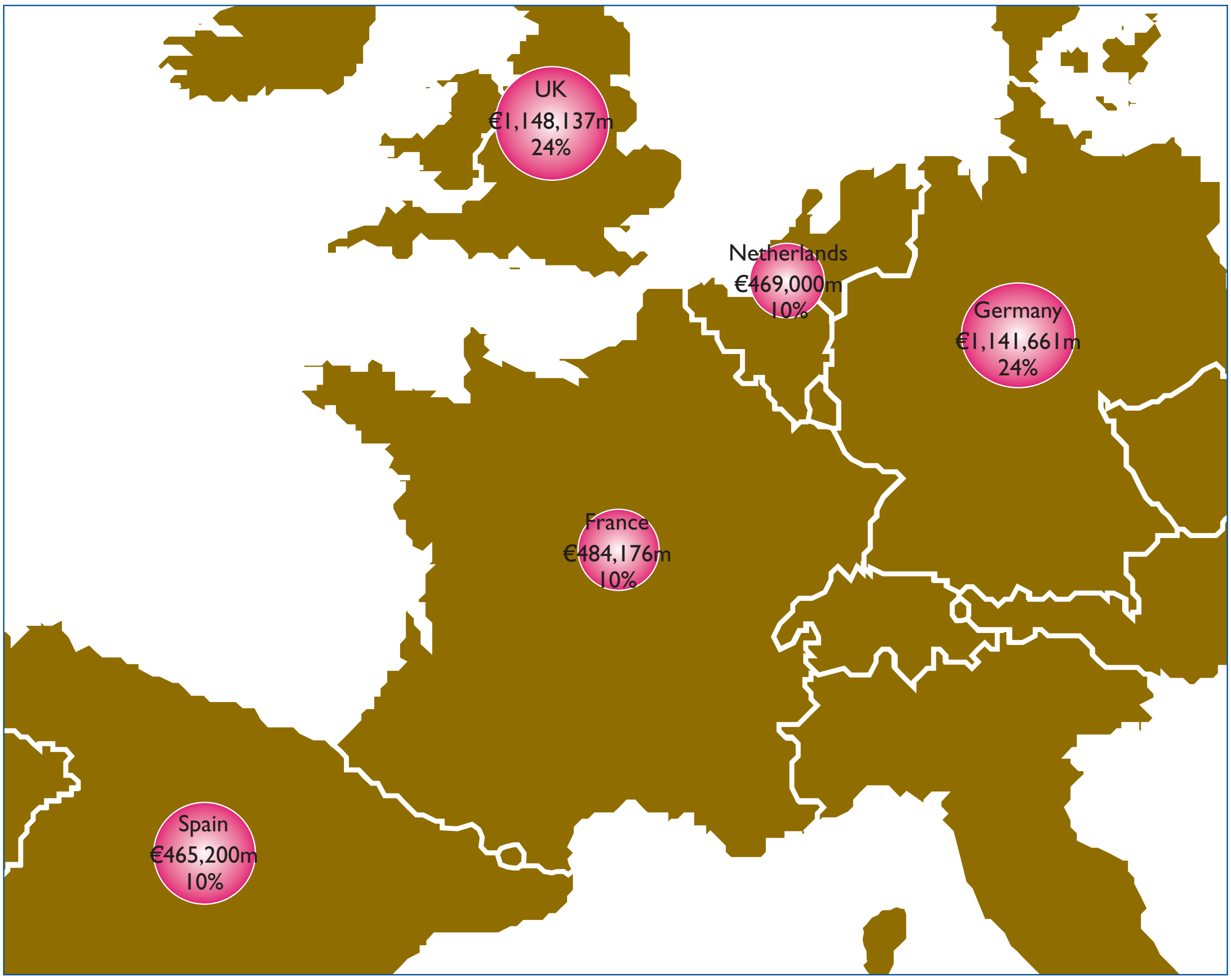
The Eurosystem which represents the European Central Bank and the national central banks of the euro zone countries, has responded positively to the EC initiative. European financial integration would facilitate a smooth and effective transmission of a single monetary policy across the euro area, which is a key objective of the Eurosystem. Other recognised benefits to the Eurosystem would be an improvement in the efficiency of large value payment systems, availability of financial instruments and liquidity of markets throughout the euro area.

Why are the Markets So Different?

The European Mortgage market accounts for a substantial part of the EU economy, with €4.7 trillion residential mortgage debt outstanding in 2004, representing 45% of EU GDP. The five largest residential mortgage markets by total mortgage debt outstanding and market share are summarised below:

Germany and the UK are the largest mortgage markets, accounting for approximately half of all mortgages outstanding. These markets are the most mature with annual growth rates of less than 10%. Greece, Spain and Ireland experienced strong growth of 20%-30% in 2004. Central and Eastern Europe are

Five Largest Residential Mortgage Markets in Europe (2005)



Key:
€m – total mortgage debt outstanding (EUR million, 2005)
% – of total EU

"virtually doubling in size year after year as demand from borrowers drives the supply from lenders" (Judith Hardt, European Mortgage Federation). Eastern European countries are slowly developing from the impact of communism, and consequently have a legacy of low home ownership levels and unfamiliarity with the legal processes surrounding mortgage lending and private property ownership.

European mortgage markets retain strong national characteristics with considerable differences in systems and products as a result of the varied political, legal, regulatory and historical environments in which mortgage lenders operate. Capco and Greenwich Business School are in the middle of some extensive research across the European residential property markets, addressing aspects such as valuation, regulatory and state intervention differences, consumer behaviour and lending profiles. From this work it is clear that the current state of mortgage provision in each country is primarily a result of history. For example, the UK building society movement, despite demutualisations and takeovers, can still be seen as the core source of mortgage market share. Another example is Denmark, where the destruction of Copenhagen in a fire over 200 years ago led the government of the time to fund its reconstruction through very long term mortgage finance.

Output from the early stages of the Capco and Greenwich Business School study concluded that the key differences across the residential European mortgage markets include:

State Intervention: Intervention can take many different forms, including provision of subsidised social housing, the ownership and management of financial institutions and supporting of funding for lending. Each market has differing levels of intervention, for example, France and Germany are more regulated than UK.

Tenure: There are differing levels of rented and owner occupied residences across each market. Spain, the UK, Portugal, Ireland and Greece have owner occupation in excess of 70% of housing stock whilst Austria, Denmark, France, Germany and the Netherlands have less than 60%. This is due to a combination of factors, including consumer preferences and government intervention.

Mortgage Funding: In France, Germany, Greece and the Netherlands over 50% of funding is long-term fixed rate, whilst the in the UK the bulk of funding is still variable rate. These differences are mainly due to the level of state intervention and types of funding instruments used. Loan to value (LTV) ratios differ greatly, with many loans in Holland being at an LTV of over 100%.

Market Turnover and Cost Structure: Level of transactions relative to housing stock varies between different countries. The UK and Ireland have transactions of between 8.4% and 8.3% respectively whilst Germany is 3.4% and Italy 3.8%. These differences are related to the rate of house price inflation and costs and tax regimes associated with house sale and purchase.

Competition: Generally, the larger the market size the higher the level of competitiveness. Germany and the UK are the largest markets are both highly competitive in terms of industrial concentration. Denmark and Portugal are small markets with high levels of concentration.

Price Movements: The market can be divided into those with rapid price rises (UK, Ireland and Spain), those with medium prices rises (Belgium, Denmark, Italy, Netherlands and Sweden) and Germany and Switzerland who have seen no house price inflation in recent years. Historically, the UK market has experienced rapid price rises but this has slowed over the past year.

Room for Innovation

Consumer behaviour will, to some extent, bring the need for change. Recent statistics in the UK show over 257,000 households now own properties abroad. Despite this growth in foreign house purchases, cross-border trade mortgage loans across the EU are rare, with less than 1% of mortgage holders obtaining a mortgage in a foreign country. Consumers tend to be hesitant towards cross-border trade as mortgage products are difficult to understand and hard to compare. According to a Eurobarometer survey, 5% of consumers across Europe would consider buying a mortgage in another EU country in the next 5 years. Most of these consumers are expected to be senior business executives. This suggests that some growth in cross border mortgages is expected but this is limited. Cross border lending will only occur if the consumer has the same level of understanding, trust and confidence in products sold cross border as in domestic products.

Cross-border entry of lenders into foreign banking markets has been static over recent years. In the majority of EU countries, foreign lenders account for around 10 to 25% share of the market. This low penetration rate tends to be due to barriers to entry, such as governments' reluctance to permit foreign firms to take over domestic banks, and low margins on mortgage products in some countries. Those foreign lenders entering the market tend to favour merger and acquisitions (eg Santander and Abbey) as these provide the benefits of physical presence, established branch network and a workforce with language, locally based branding, skills and knowledge. Given the complexity of mortgage products they require advice and face-to-face interaction making branches the main distribution channel for selling mortgages. Over half of all mortgages across Europe originate in branches. Multi-country lenders tend to use branch networks as the primary channel of distribution in foreign markets. However, technological improvements may increase the use of the Internet as an origination channel. Research by the Financial Services Industry Council indicates that around 5% of European mortgages in 2003 were arranged using the Internet. This number could rise to 16% in the next few years. Given the high costs associated with originating and servicing mortgages, the Internet may provide a more cost effective distribution channel in the future.

The demographic crisis facing Europe in terms of an aging population will mean that governments may start to devolve the risks of aging to private individuals and thus their welfare will depend more heavily on the behaviour of their major asset housing. Equity release products in the UK and reverse mortgages in the US are examples of products designed to make property more of a liquid asset.

Conclusion

Given the differences between the European domestic mortgage markets, change will not happen quickly, even with EU intervention. Extensive changes in regulation and taxation would be required to integrate these markets which would take significant time to implement. The extent of integration required between the markets will not be known until the publication of the EC's recommendations and proposed integration initiatives. The rate of property churn and differences such as ownership levels will dampen the effects of any legislative changes in the immediate term.

Product innovation within domestic markets is expected to continue with the shift towards more flexible mortgage products such as 100% plus mortgages, extended terms, capped variable products and adjustable rate mortgages. There is also likely to be an increase in the use of bundled or 'universal' mortgage products.

Some simple innovation at the edges of the cross border lending market, for example in multiple property ownership, and cross-border property deals is to be expected in the short term. The number of consumers buying properties abroad will continue to rise slowly which will, in turn, increase demand for the 'euro-mortgage' and other multi-currency products. The growth of cross border lending is dependent upon lenders removing barriers such as consumers' lack of understanding, trust and confidence. Standardisation of information and greater 'transparency' of products would help to remove these barriers by encouraging consumers to shop around and compare products across borders.

Mergers and acquisitions are expected to continue across Europe as lenders seek to enter foreign banking markets with an established branch network and a workforce with language, skills and knowledge. This will increase cross border lending as foreign lenders are able to distribute mortgage products to non domestic consumers via the branch network, the primary distribution channel in most European countries. Sales of mortgage products over the Internet are also predicted to grow over the next few years which will also encourage the growth of cross border lending.

A harmonised European mortgage market may be a long term goal, but the position of residential property in household wealth, and freeing up this asset for long term care, may be more important factors in changing and aligning markets.

Sources:
ABC Money.co.uk; EU Mortgage Market Integration (European Parliamentary Financial Services, 2005) & The Costs and Benefits of Integration of EU Mortgage Markets (London Economics, August 2005); European Mortgage Federation calculation based on EU12; Global Mortgage Origination Trends (Financial Services Industry Council, June, 2005); Internal Market & Financial Services (European Mortgage Federation Annual Report, 2004); The Development of The Reverse Mortgage Market (Capco Journal of Financial Transformation: Bill Irving, Capco and Tom Roughan, Capco, 2005); The European Commission's Green Paper on Mortgage Credit in the EU, Eurosystem Contribution to The Public Consultation (European Central Bank, December 2005); The European Residential Property Market: A Series of Structural Anomalies (Capco Journal of Financial Transformation: John Smullen, University of Greenwich Business School & Keith MacDonald, Capco 2005)

European Charter for Housing: European Principles for National Housing Policy

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

For more than a year the "Urban & Logement" inter-parliamentarian group of the European Parliament has been working on a Charter for housing policy. The result of these discussions was forwarded to the President of the European Parliament on 26 April 2006 in the context of the "Charter for Housing" in order to have it discussed in the Parliament's plenary session.

As a general principle, housing policy falls outside the competence of the European Communities. Nevertheless, many legislative initiatives of the European Commission and decisions of the European Court of Justice have a direct impact on the national housing policy of the Member States. The authors of this Charter for Housing are very aware of the fact that the EU does not have a direct competence in housing policy. Their aim is to appeal to the national and the European legislator to remove the existing drawbacks related to the housing situation in several Member States.

The objective of this group is on one hand to raise awareness in the European Parliament of the housing situation in the Member States and, on the other hand, to codify the right of housing in a legally non-binding resolution. The Charter states that housing is a fundamental element of human dignity as well as an essential part of social policy and the social security systems of the EU Member States. It also calls upon the Member States to ensure that citizens are able to rent accommodation of a certain average and adequate standard.

The main objective of the "Charter for Housing" is to make housing a fundamental right in the EU. In this context, the problem of homelessness, affordable housing in the big European capitals and sufficient supply of social housing by the State are the main focuses. Thus the Charter emphasises the impact of good housing policy. It comes to the conclusion that a functioning housing market fosters social peace; European citizens would be more mobile and thus could exercise their right of free movement. The labour market would be supported and economic growth in Europe in the sense of the Lisbon strategy would be facilitated.

European institutions are called on to adjust European politics accordingly in order to create an environment that allows Member States to implement their national housing policy according to the Charter's objectives. But the European legislator also has to assess every measure as to whether it intervenes in housing policy.

The reasons of the Charter state that in particular the new Member States have an increased demand for renovation and maintenance of dwellings. In addition, the more than 60 MEPs represented in this group ask for maintaining the current European VAT provisions which allow Member States to apply a reduced VAT rate for the housing sector.

The Charter for Housing will be discussed and adopted in the Plenary of the European Parliament within the next few months. So at least the European Parliament will give a sign that the existing problems concerning the supply of housing in the individual Member States are known on the European level. It is appealed to the European Commission but also to the EU Member States to create an environment guaranteeing sufficient housing space.

[1] www.efbs.org

New Members

A very warm welcome to four new members of the International Union –

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4. Federal Housing Finance Board, USA – **www.fhfb.gov**

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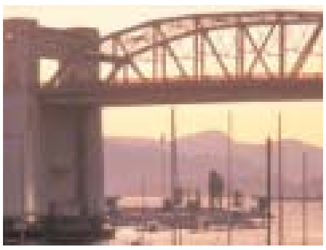


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