Looking for Optimal Financing – Transfer from Classical Forms of Financing to Innovated Ones

By

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Ladies and Gentlemen,

Voltaire supposedly said: "If you see a Swiss banker jump out of the window, jump out after him. There is surely something to be gained." But the advice is not so simple when it comes to locating the ideal housing finance solution. This is particularly true when we look at the many products available which are often described as "innovative" or "new".

The focus of our attention must always be the consumer and the property in question when considering the "right" financial products. We have to look at the customer's present financial situation as well as his future earning potential, and the marketability of the property.

In my observation there is one common requirement placed on housing finance throughout Europe: It must have a secure basis. This is true for wealthy customers as well as for those for whom buying a home is the single greatest financial challenge of their lives.

If we take this requirement seriously, the "traditional" financing methods don't look too bad. They offer the customer continuity and financial reliability. Both the mortgage and the "bauspar" loan have repayment plans which remain constant over many years. And considering the fact that the conditions for many mortgages are normally renegotiated an average of two times over the life of a thirty year loan, the "bauspar" loan has the added advantage that it's repayments remain constant for the entire period of repayment.

It was not so long ago that variable interest rate loans were celebrated as an innovative method of financing. However when interest rates rose in the early eighties many customers were forced to default. And this in turn had a very negative impact on the entire banking industry. Many voices of dissent were heard.

Let us now turn to the so-called innovative financing products. First I need to point out that it is not only the traditional finance institutions which offer housing finance. In the Internet age more and more players are entering the field who do not themselves offer financing. Rather they are service specialists who optimize the mortgage process or find the best finance package. We can observe the market dividing into three segments. Previously there was just a division between retail (advisory, or home bank) and finance (mortgage bank). Now there is another element working between these two whose job it is to find the best housing finance package for the customer. Particularly in the Netherlands this specialty, based on the US-model, has developed. The market share for this kind of provider is about thirty per cent. These providers have specialized in process optimization. In order to remain competitive, traditional mortgage banks will have to secure these providers as outsource partners. A technology-based service platform makes the necessary cost reductions possible and enhances competitiveness.

I view this development very positively. Funding private properties no longer provides the majority of credit institutions enough margin to operate profitably. New, or I should say, optimized channels are the way of the future. For financial service institutions there is still a great deal to do in the field of housing finance. The potential construction volume in Europe is still enormous. This applies to all countries but particularly to the countries of Central and Eastern Europe. While it is perhaps true that growth is not always oriented towards new construction, modernizations and renovations also need to be financed.

In the search for an inexpensive loan for his "own four walls" the prospective home owner haggles for hours over every tenth of a percentage point. As far as the simple mortgage banks are concerned, the retail business has not been profitable for years. Moreover, as a specialist bank, the mortgage banks in Germany are subject to the restrictive confines of the German Mortgage Bank Act. In order to remain competitive, mortgage banks need to develop new strategies. Several trends are now recognizable in this area. First many mortgage banks are merging in order to take advantage of clear cost savings. Secondly following a different tactic, retail home lending businesses are being assigned to the branches of their parent companies. Finally in the mortgage bank sector there is a concentration on major commercial accounts.

In all of these observations one feature in particular is of special importance. Real estate loans are very country-specific, one could even say traditional. In my assessment, housing finance in many countries is similar to a kind of relay race. Financing structures that have been tried and tested over generations are employed and will continue to be used in the future. In this context it must also be said that it is very difficult for foreign credit institutions to enter new markets; individual countries do not tire in putting obstacles in the paths of foreign competitors. This starts with the standards employed for the provision of security and goes all the way to what can be done with a property if the buyer defaults on his loan. Foreign finance institutions must, of course, apply the local laws. And property laws are very different from country to country; many a pitfall may be in store for them. In order to create uniform conditions, the legal systems must be harmonized. But even in an increasingly globalize world this can take a long time. Legal systems are bastions which cannot simply be reshaped in a virtual world.

In times in which the stock exchange is worshipped as a golden calf, more and more speculative elements are creeping into the housing finance business. I would like to highlight two of the existing options here in Europe. The first is financing real estate using loans in low interest foreign currencies. This can be quite tempting. Take the Japanese yen for example. Depending on term, loan amount and credit worthiness, yen loans are currently to be had for a no minal rate of just under two percent. This is something that German home buyers can only dream about, although at around six per cent, long-term mortgage credit in my home country ranks us in the bottom third.

Taking out a loan in Switzerland is also worth looking at. Credit in Swiss francs is currently some one-percentage point more favorable than in German marks.

The interest savings are impressive. The other side of the coin, however, is the risk that the interest rate advantage will evaporate or even be reversed by changes in the exchange rate. The weaker the euro, the greater the risk. If the rate of the foreign currency rises, the interest must be paid in yen or francs and payments settled at the current rate of exchange for the home currency.

If the speculation on a strong euro is successful, good profits will be there for the taking in addition to the cheap credit. But the risk is enormous in the case of a long-term property credit. This is nothing more than a risky bet. For this reason, foreign currency loans are not the right choice for the majority of home finance plans. Most families do not have enough money to afford such a daring borrowing scheme.
This is also true for another option. Some people refer to it as a turbo-charged engine for repayment. But as experienced Formula I fans know many a turbo-charged engine has to contend with a fair number of misfires and complete failures are not uncommon.

So is the situation with annuity loans. The borrower regularly pays the interest on the loan together with repayments. The alternative is the repayment-free model. Here only the interest is repaid on a monthly basis to the credit institution with the loan repayment due in total at the end of the term. In order to pay off the loan at the end of the term, the repayments go into an investment fund. Here however, one is dependent on the ups and downs of the stock exchange. In a bull market, this is if the prices rise, the repayment of the loan will not be endangered. But what if the reverse happens or the wrong fund is chosen? Many borrowers will be sweating blood and tears if their funds do not perform well. This option is really only suitable for wealthy borrowers.

In the Eastern European countries, a uniform trend in financing strategies cannot yet be seen. There are at present various developments in the field, but western economies are the model. It is, of course, important to create a reliable legal framework, which includes such items as the legal assessment of property. But just as important is a stable financial framework where inflation is managed. Truly stable conditions are probably still a way in the future.

In conclusion, I would like to tell you a German saying: Cobbler stick to your last! And just like the cobbler sticking to what he knows, I would also suggest that for most of our customers, security is the highest priority. With this approach all involved will gain. From this point of view, the traditional financing models don't look too bad after all. They are in line with the customer's wishes and needs.