

HOUSING FINANCE INTERNATIONAL

The Quarterly Journal of the International Union for Housing Finance



- **The super-rich and the globalisation of prime housing markets**
- **25 years of National Housing Bank**
- **Latest ideas on the structural reform of the banking market and its effect on housing finance**
- **Does Australia's National Consumer Protection Act limit practices that can lead to housing over-indebtedness?**
- **Mortgage credit and fiscal benefit in the Netherlands**
- **Affordable housing in Tunisia: opportunities emerging from the Arab Spring**

International Union for Housing Finance

Housing Finance International

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E-mail: hamm@housingfinance.org

→ Head of Department of Economic Affairs:

MARK WEINRICH,
E-mail: weinrich@housingfinance.org

→ Publisher:

HARTWIG HAMM

→ Editor:

ANDREW HEYWOOD

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For further details, please contact Anja Gruhn
(gruhn@housingfinance.org)



International Union for Housing Finance

Rue Jacques de Lalaing 28, B 1040-Brussels - Belgium

Tel: +32 2 231 03 71

Fax: +32 2 230 82 45

www.housingfinance.org

Secretary General: Hartwig Hamm

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Editor's introduction

Are housing markets international?

↳ By Andrew Heywood

Since the last issue of *Housing Finance International* [HFI] there have been two major international conferences with links to the IUHF or its affiliates.

The first, held in April 2013 was *Housing; an inclusive engine for economic growth*, a conference organised in Delhi by the National Housing Bank [NHB] of India and the Asia Pacific Union for Housing Finance [APUHF].

This was a global affair focussed primarily on affordable housing. It included delegates from the World Bank and a range of international financial institutions. However, the emphasis was on the Asia-Pacific region and the fact that very limited representation from Western Europe, a traditional focus for debates on affordable housing, did not detract from the significance of the conference as a whole is a timely reminder that the centre of gravity is moving firmly eastwards in terms of global investment in housing and of the housing debate itself.

The second event was the Joint Congress of the IUHF and the European Federation of Building Societies. Held amongst the Imperial splendours of central Vienna from the 5th to the 7th June the emphasis was on sound finance in relation to private housing markets in the aftermath of the financial crisis, although there was also a valuable session examining how housing investment could be extended to underserved markets. Like the Delhi conference it was a highly successful event and a report on the proceedings is included in the regional roundup for Europe later in this issue of HFI.

The conferences are a valuable illustration of the fact that academic and professional discussions on housing finance are becoming increasingly international and provide evidence of a strong desire by both commentators and practitioners to learn lessons from the experience of others at a global level.

Yet there remain doubts as to how international housing markets themselves really are. There are, of course, international players in both the primary and secondary funding markets and similarities in terms of legal structures. In terms of formal process in relation to concepts such as arrears or foreclosure different jurisdictions often have much in common. Yet housing markets as dynamic entities are still by-and-large regulated at a national level, although Christian König's article in this issue of HFI on proposals for structural reforms to the banking system itself is a reminder that the European Commission is just one of a number of organisations attempting to take a transnational view. Nevertheless, housing markets are delineated at a national level by differing legal systems, while housing market data still tends to be collected on a country by country basis.

The above two conferences, international as they were in tone and perspective, also contained reminders about how different specific countries and regions can be. In India mortgage debt to GDP is around 9%, in the UK it is over 80%. In much of the Asia-Pacific region home ownership levels are rising rapidly, although from a low base. In contrast, Western Europe is now starting to confront the issues raised by falling or stagnating home ownership together with a growing private rented sector. In common with much of South America, Mexico has targets to produce new affordable housing (much of it using so-called modern methods of construction) that dwarf those of Europe and Australia.

In the first of the full-length articles in this issue Chris Paris examines one sub-sector of housing markets that is truly international; the super-rich. Paris points out that this group are buying appreciating assets in secure locations where they can live or retreat for some of their time and which can facilitate a range of other activities from education, to tax avoidance. Paris shows that the activities of this group are poorly captured in terms of housing market data, but that the influence of this transnational group

of investors can be to de-couple certain sub-markets (such as Inner London for example) from the broader "national market" of which they are often thought to be simply a component.

The National Housing Bank [NHB] of India is now 25 years old. In a fascinating article, RV Verma, the Chairman and Managing Director of the NHB, takes a backward look at an institution that has made its name by successfully taking a market orientated approach to the provision of affordable housing in the World's second largest country by population.

Following Mr. König's article referred to above, the scene shifts to Australia. Mary Tomlinson analyses the Australian mortgage market in the post-banking crisis period. Australia survived the crisis relatively well compared to much of Europe and the US and Australian lenders claim that their market was not characterised by the type of irresponsible lending identified elsewhere. Nevertheless, there are worrying signs of a build-up of household debt and Ms Tomlinson asks whether the National Consumer Protection Act 2009 will prove effective in curbing excess.

The Netherlands is one of a number of countries, including Switzerland and the US, that allow home owners to deduct mortgage interest payments, in whole or in part, from taxable income. In a closely argued article Fred Pallada and Hans Mersmann analyse the scope and impact of mortgage interest tax relief in the Netherlands and ask whether the scheme operates equitably across different income groups.

Finally, Josie McVitty addresses some of the issues confronting housing policy makers in Tunisia following the Arab Spring. McVitty analyses the housing market in Tunisia and focuses on the challenges and opportunities to step up the supply of affordable housing in that country.

All in all, this Summer 2013 issue of HFI is a very good read indeed.

Contributors' biographies

Christian König works as Head of Legal Affairs for the Association of Private Bausparkassen in Berlin and is responsible for all German and European legal affairs dealing and affecting the business of Bausparkassen and other credit institutes financing home ownership. The scope of his work includes the evaluation of legislative proposals of the European and German Institutions, dealing with banking, contract and consumer protection law. He is currently involved in the discussions of the consumer and mortgage credit legislation on the European level.

Josephine McVitty is an associate with the Affordable Housing Institute. Her work spans research and advice on policy, housing finance, real estate development, and public-private partnerships to improve access to affordable housing in emerging markets. In the past year, assignments covered Tunisia, Algeria, Morocco, Iraq, Djibouti, South Africa, Nigeria and Haiti.

Hans Mersmann is the Dutch director/owner of Woonresearch, a research bureau for studies regarding the mortgage and housing market. He set up this bureau after his retirement in 2011 from the Foundation Home Ownership Guarantee Fund in the Netherlands. He was director of strategic and foreign affairs as well as deputy managing director. In addition he works at the Erasmus University Rotterdam. He completed his study at the University of Amsterdam as Master of Economics, specialising in advanced price theory.

Fred Pallada started his professional career as an economist at the Netherlands Bureau for Economic Policy Analysis [CPB]. Later he joined the financial industry, the last fifteen years as a senior research executive at ING, a Dutch Bank

Assurance company. He delivered several scientific research papers on various subjects. Now he is an independent analyst and commentator and is working for Woonresearch.

Chris Paris is a Research Fellow in the Centre for Housing, Urban and Regional Planning, University of Adelaide and Emeritus Professor, University of Ulster. He has held senior academic posts in the UK and Australia. He is author of 30 books, monographs and research reports and over 100 journal publications.

Alex J. Pollock is a resident fellow at the American Enterprise Institute (AEI), a former President and CEO of the Federal Home Loan Bank of Chicago (1991-2004), and a Past-President of the IUHF. He can be reached at apollock@aei.org.

Zaigham M. Rizvi is Secretary General of the Asia Pacific Union for Housing Finance, email: zaigham2r@yahoo.com

Kecia Rust is the coordinator of FinMark Trust's Centre for Affordable Housing Finance in Africa, and manages the Secretariat of the African Union for Housing Finance. She is a housing policy specialist and is particularly interested in access to housing finance and the functioning of affordable property markets. Kecia holds a Masters of Management degree (1998), earned from the Graduate School of Public and Development Management, University of the Witwatersrand. She lives in Johannesburg, South Africa.

Ronald A. Sanchez Castro is Economist and Master of Finance at Federico Villarreal University in Peru. He is a researcher and consultant on finance, housing and urban development, and

is Technical Secretary to the Inter-American Housing Union (UNIAPRAVI). Email: atecnico@uniapravi.org

Mary R. Tomlinson is a Visiting Fellow at The Swinburne Institute for Social Research. Tomlinson spent 30 years living and working in South Africa where she focused on the delivery of housing finance to the historically disadvantaged population. In 2009 she moved to Australia where she now examines Australia's housing finance system and, in particular, how risk is managed and whether conditions exist for unsound lending practices to occur.

R. V. Verma is Chairman and Managing Director of the National Housing Bank of India. He has worked on various policy-related developments and execution oversights to develop the Indian mortgage market. He has designed and guided the development of the mortgage market in various capacities and worked on policy initiatives, on regulations and on supervisory oversight of housing finance companies. Mr. Verma has also worked in close association with policy makers, in relation to fiscal, monetary, credit and housing policies at the Union and State levels. He has participated in various country dialogues at national and international levels. Mr. Verma also holds the position of the Chairman of the Asia-Pacific Union for Housing Finance [APUHF].

Mark Weinrich holds graduate degrees in political science and economics from the University of Freiburg, Germany. He is the manager of the Department of International Affairs in the Association of Private German Bausparkassen. He is the Head of the Department of Economic Affairs for the International Union for Housing Finance in Brussels.

News of the IUHF



Cas Coovadia (left) congratulates Andreas Zehnder on his election as next President of the IUHF

New president elected

Andreas J. Zehnder, President of the Association of Private Bausparkassen (Germany) and Managing Director of the European Federation of Building Societies (Brussels) was elected president of the International Union for Housing Finance (IUHF) by the Council of Members. He is the successor of Cas Coovadia of the Banking Association of South Africa, who had held the post since 2008 and is now Vice-President. Zehnder belongs to the Executive Committee

of the International Union since 1996 and was already involved in the organisation of the Union's Congress in Washington D.C. in 1989.

Furthermore, the members of the Executive Committee were designated: Pekka Averio (Municipality Finance, Finland), Jay Brinkmann (Mortgage Bankers Association, United States of America), Colin Chimutsa (African Union for Housing Finance, Zimbabwe), Adrian Coles (Building Societies Association, United Kingdom), Johann Ertl (Raiffeisen Bausparkasse, Austria), Yarza Jorge Garrido (Uniapravi, Mexico),

Renu Karnad (Housing Development Finance Corporation, India), Herbert Pfeiffer (PSS Building Society, Slovakia), Jiří Šedivý (Association of Czech Building Savings Banks, Czech Republic), Chatchai Sirilai (Government Housing Bank, Thailand), and Kapil Wadhawan (Dewan Housing Finance Corporation, India). The general secretary of the International Union for Housing Finance, Hartwig Hamm, Managing Director of the Association of Public Bausparkassen (Germany), is also an ex-officio member of the Executive Committee.

Housing finance news from Africa: mechanisms to stimulate affordable housing markets

↳ By Kecia Rust, African Union for Housing Finance

In the past few months, the AUHF has participated in two local meetings – the one, co-hosted with Abbey Building Society in Nigeria; and the other co-hosted with the FinMark Trust in Zambia. At both sessions, delegates from the local housing sectors presented status reports on their industries, which together illustrate a sector that is rapidly developing across the continent. A key issue faced in both contexts, was the affordability of housing for the majority of the population.

At the AUHF regional seminar in Lagos, Nigeria, the planned establishment of a private sector led and managed mortgage refinance company was discussed. The initiative is part of a wider Housing Finance Programme initiated by the Federal Ministry of Finance, with the support of the World Bank. The planned Mortgage Refinance Company will be similar to Tanzania's Mortgage Refinance Company, set up as a public-private partnership arrangement, a secondary market institution providing long term funds to mortgage lenders. It will issue long-term bonds in the Nigerian financial market and then channel the proceeds to member institutions at a competitive rate. It is expected that the company will be in place by the end of the year, and through its intervention in the financing of housing in Nigeria, delivery projections of up to 75 000 houses per annum were expected – a significant increase on the current delivery rate.

A major challenge for the initiative, however, is Nigeria's poor foreclosure procedures. In order for a mortgage refinance company to work, recourse against non-payment is critical. This issue was highlighted by a number of participants at the AUHF Seminar, including the Executive Secretary of the Mortgage Bankers

Association in Nigeria [MBAN]. Legislative intervention was needed but in the meantime, the MBAN was working on uniform mortgage underwriting standards to assist Nigerians in better understanding mortgage application procedures. Mortgage default insurance that provided a bridge of support to enable a non-performing loan to cure was also under consideration. Like the planned mortgage refinance company, the MBAN had clear goals for the development of Nigeria's mortgage market over the next five years: (1) to grow the mortgage market ten-fold, from its current size of 20 000 mortgages, to 200 000 mortgages; (2) for the mortgage to GDP ratio to grow to at least 15% (the World Bank's figure for Nigeria's mortgage to GDP ratio in 2008 was 0.39%); and (3) to deepen the mortgage culture in Nigeria so that the instrument became a more regular mechanism for financing housing.

While appropriate foreclosure legislation and practice is obviously an important issue in the growth of Nigeria's mortgage market, a developer at the meeting argued that access to finance was constrained by banks' narrow conception of "income". Formal banking products relied on formal income, but ninety percent of Nigeria's economy was in the informal sector, and even formal workers augmented their income with informal sector work. Accessing the affordability capacity and potential of the informal economy was therefore a critical opportunity for the housing finance sector.

A further issue, also raised by the developer, was the housing delivery process itself. He argued that Nigeria's housing need was estimated at over 15 million units, comprising over a million civil servants (teachers, police personnel, public servants at state and federal levels, and military

personnel), half a million students, and millions in the informal sector. The National Housing Policy of 1991 included a federal government target to deliver 8 million houses by the year 2000 and at least 700 000 houses per annum. This target had never been – and would never be – met by government on its own. Government should not take on the responsibility of housing construction, but should rather work in partnership with financiers and developers to ensure that housing goals were met by everyone working in the area of their core business: government as the regulator, financiers as the funder, and developers as the builders. His presentation highlighted a number of developments that were never filled, or which had fallen into neglected, largely because of the inappropriate allocation of roles, responsibilities and accountability across the parties.

The Director of Mortgages at the Ministry of Housing for Lagos State then spoke about the Ministry's plans to stimulate housing construction for the affordable target market in Lagos State. In terms of the arrangement, Lagos State would provide the land and infrastructure for free or a very limited charge, for developers to build target market houses. Once the houses were completed and confirmed to comply with the rules and regulations of the programme, the Ministry would buy all the units from the developer, taking away the marketing risk. The units would then be offered to first time home buyers through the Lagos State Home Ownership Mortgage Scheme, which offered a 6 percent interest rate on a 70% loan to value mortgage over ten to twenty years. This would be managed by the Lagos Mortgage Board.

The purpose of the meeting in Lusaka, Zambia, was to launch research recently commissioned by

FinMark Trust and its Centre for Affordable Housing Finance in Africa, setting out the state of housing finance in Zambia. The research was undertaken by Knight Frank Zambia, in partnership with the Peoples Process on Housing and Poverty in Zambia (a local NGO), and Planet Finance.¹

Overall, the study found dramatic growth in Zambia's residential mortgage sector: between 2008 and 2012, the commercial banks mortgage portfolio almost doubled, from ZMW 698 million, (\$139.6 million), to ZMW 1.208 billion, (\$241.6 million). This, in a context where mortgage finance was expensive, with interest rates hovering just under 20% (the lowest bank mortgage rate is currently 15%; building society mortgage rates hover around 22-24%; a recent product offering by Zambia National Building Society, with a 12 percent rate is thought to be unsustainable in the current economy). As a result, households finance their housing in other ways. The most common route to homeownership is through incremental self-build, often with individuals using cyclical loans to reduce the overall cost of borrowing.

The study segmented Zambia's housing market into three zones:

- **Served Zone:** this comprised approximately 3% of Zambia's population (about 80 000 households) who had access to mortgage finance. With incomes greater than about US\$1 000 per month, they would be able to borrow upwards of US\$16 000 over five years. Mortgages in this category, however, were very expensive – prevailing rates among building societies are as high as 24% and the lowest rate offered by a bank was 15%. As a result, loan tenors were generally about five years.
- **Enablement Zone:** this comprised approximately 6% of the population (about 150 000

households) with a monthly income of about US\$400 – US\$1 000, who could possibly afford a loan of about US\$7 000, assuming 35% interest over two years. While they had access to financial products, this access was limited to the more expensive products. The segment included formal sector employees, as well as some informal sector workers.

- **Empowerment Zone:** this comprised the remaining 91% of the population (about 2.6 million households), who had a monthly income of less than \$400. This group is largely excluded from access to the products offered by most service providers in the housing finance value chain. Where finance was available, it was through credit unions and community based support groups.

Across all three zones, the dominant form of construction was self-build with multiple financial products sourced from banks and MFIs (served zone), employers, family and friends (enablement zone) and credit unions and community based support groups mobilising savings (empowerment zone). Limited access to housing finance undermined the housing supply sector, whose low delivery rates in turn undermined the growth of the housing finance sector. The study found that there was considerable room for expansion of the housing finance market in Zambia across all three zones. Macro financial sector reforms and the creation of a more enabling environment were highlighted as necessary to reduce interest costs, and increase credit by lenders to long-term credit lines. At a more micro level, the providers of housing finance needed to invest in product innovation to tailor their products to specific market segments and price more accurately for risk. At the same time, interventions to stimulate the supply of affordable housing were also necessary.

The discussion at the Zambian seminar raised many similar issues to those raised in Nigeria. A banker argued that a key issue constraining the growth of Zambia's mortgage market was the need for long-term finance and the fact that investors could achieve 14.5% when investing in government bonds. This meant that any long-term money that lenders could secure would be expensive – a cost that would then be passed on to the borrower. Because building societies were registered as non-bank financial institutions, they couldn't access pension or insurance fund investments. Indeed, access to affordable capital was the issue that Nigeria's mortgage refinance company was designed to address. Legislative constraints undermining the growth of the mortgage industry were also raised, as they had been in Nigeria. In Zambia, the building societies and financial services legislation was out-dated and needed to be modernised; and a backlog in titling undermined the mortgage sector. Given the constraints outlined in the report and reinforced by the seminar participants, it seemed Zambia's mortgage market was growing despite itself.

The two seminars, held in two very different countries with two very different contexts, revealed remarkable similarities. Clearly the growth of housing finance markets across the continent can benefit from an exchange of experiences, lessons learned, and challenges faced, as governments, practitioners and households strive to improve their local housing circumstances. These are some of the issues that the African Union for Housing Finance will address in its **upcoming conference**, to be held **11-13 September 2013** in Mauritius, under the theme "**Mobilising Capital for Housing Finance**". For more information about the conference, contact Lorraine Nzimande on Lorraine@housingfinanceafrica.org

¹ The research report can be downloaded from <http://www.housingfinanceafrica.org/document/scoping-study-overview-of-the-housing-finance-sector-in-zambia/>

Asia Pacific region: news update Q2, 2013

↳ By Zaigham M. Rizvi, Secretary General of the Asia Pacific Union for Housing Finance

India

According to the latest report on the housing shortage by the Technical Group on Urban Housing Shortage in India-2012, India had an urban shortage of 19 million units, down from 27 million a few years back, while the rural housing shortage stands at 44 million units. Nearly 96% of the urban shortage is in the Low Income Group-LIG and Economically Weaker Segments-EWS of society. India has recently revised upward the definition of EWS at income up to \$ 160 p.m. and LIG at income from \$160-\$320. p.m.

As of 2013 there are 57 Housing Finance Companies [HFCs] in India, out of which 19 are permitted to mobilize deposits. These HFCs are playing an important role, alongside commercial banks in expanding housing finance in India, with outstanding mortgage debt standing at over IRs 7 trillion.

India is in the process of adopting the Micro Finance Institutions Bill-2012. The Bill is to address the challenges faced by the micro finance industry and its development. The Bill seeks to empower the Reserve Bank of India to regulate the micro finance industry and fix interest rate ceilings on loans to be provided by lenders.

The Indian housing sector has taken quite a few new initiatives and a number of important developments in nearly all major areas of housing and housing finance. These are of a continuing nature. Some of these developments are:

NHB-RESIDEX: The housing price index covers 20 cities. The Residex is expected to bring greater uniformity and standardization as well as greater transparency in the valuation of properties across the industry.

CGTFLIH [Credit Guarantee Trust Fund for LIH]: The CGRFLIH has been formed with an objective of providing a credit risk guarantee for affordable housing loans up to IRs 5 lakh sanctioned and disbursed by the lending institutions and for housing units of up to 430 square feet (40 square meter) carpet area, to new or existing borrowers in the EWS/LIG categories without any collateral security and/or third party guarantee.

CERSAI: It serves as the Central Registry of Securitization Assets. The records maintained by the Central Registry will be available for search by any lender or any other person desirous of dealing with the property.

The Golden Jubilee Rural Housing Finance Scheme has been conceptualized to address the problem of rural housing through improved access to housing credit which would enable an individual to build a modest new house, or to improve, or add to his old dwelling in rural areas.

Thailand

Active Thai property market:

The Government Housing Bank's Real Estate Information Center [REIC] recently announced that more than 40,000 residential units were launched in the first quarter of this year, a 40% increase from the same period last year.

Condominium units constituted about 27,500-28,000 units, (26% increase over the previous year). The REIC also noted that 68% of the units launched were priced below Bt2 million (about \$US60,000).

During Q1, about 11,500 to 12,000 single detached homes were launched in 70 housing estates, a 67% increase over the previous year.

41% of the new units were priced below Bt2 million (about \$US60,000).

REIC said that Q1's momentum has continued into Q2 and total units launched in 2013 are expected to reach 130,000 units, (101,000 units in 2012). New condominium units are expected to constitute about 63,000 units.

Thailand's housing price indices are widely used

Since 1990, The Bank of Thailand [BOT] in collaboration with the Government Housing Bank [GH Bank] has constructed quarterly housing price indices.

Because GH Bank housing loans constitute only about 33% of outstanding housing loans and are primarily for medium to low-end houses, the BOT in 2008 began constructing a second set of housing price indices using commercial bank housing loan transactions.

Today, these housing indices are widely used by economists and government officials to monitor the country's economic health.

JICA proposes new housing policy framework for Thailand

As Thailand continues developing as a major production center for global manufacturers it has become a strongly-entrenched middle-income country with rising prospects.

A recent housing sector study undertaken by the Japan International Cooperation Agency [JICA] in cooperation with Thailand's National Housing Authority [NHA] suggests that the country's current housing policy should expand its limited lower-income target group framework to accommodate future socio-economic changes.

Pakistan

Workshop on Regional & National Models of Housing Finance

SBP & the Association of Mortgage Bankers [AMB] jointly organized the workshop in March 2013 on Regional & National Models of Housing Finance. Mr. Ashraf M. Wathra, Deputy Governor, SBP made the inaugural speech. Mr. Zaigham M. Rizvi, the Secretary General APUHF, and Mr. Farhan Fasih from IFC also made presentations

on regional scenarios of the housing sector and on affordability issues.

SBP has also formed a Working Group, comprising of members from various stake-holders, to find some possible solutions to affordable housing finance issues.

Bangladesh

Bangladesh has the unique challenge of a massive housing shortage mainly in low-income housing, land scarcity and very high population

density. About 70% of urban Bangladesh lives in Dhaka, which has a population of 12 million people and a population density of more than 10,000 persons/ square kilometre. BHBFC, the only public sector specialized HFI of Bangladesh is currently expanding its outreach and has approached the World Bank for its technical and financial assistance to pursue its programs in low-income housing. Development of Community Housing is under active consideration by some institutions. A World Bank mission has recently visited Bangladesh to assess its possible role in this project.

IUHF World Congress

↳ **By Mark Weinrich, Manager of the Department of International Affairs in the Association of Private German Bausparkassen**

This June, over 160 delegates from more than 40 countries came together in Vienna, Austria, to participate in the **Joint Congress of the International Union for Housing Finance [IUHF] and the European Federation of Building Societies [EFBS]**. The theme of the Congress was “**Sound housing finance around the world**”. This subject reflects one of the most pressing issues for housing markets in many countries in the wake of the global financial crisis. Although the sessions of the Congress offered a variety of specific topics catering to the different interests of the broad and diverse membership of IUHF and EFBS, the underlying theme of the congress ran through all sessions. Two of the six sessions addressed the theme directly; the first session covered the detection and prevention of housing bubbles, and the fifth session was on how to build sustainable housing finance systems.

It was an honour that the keynote address to the congress was delivered by **Dr. Spindelegger, the Austrian Vice-Chancellor and Minister for European and International Affairs**. Dr. Spindelegger spoke during the final session and argued that housing in Austria is becoming more and more costly, so that it places a financial strain on young families, older households and other groups. Investment in housing is decreasing, yet at the same time, home ownership remains very popular in Austria: 9 out of 10 Austrians want to own their home. Dr. Spindelegger set out five working propositions to address the challenge:

- Support investment in housing by pension funds and insurance companies;
- Improve the allocation of land by reforming planning procedures and by recycling abandoned public land;
- Reduce construction costs by streamlining building regulations;
- Address the demographic changes shaping demand for housing (e.g. the increase in the number of single households);

- Contain speculation in housing markets by making other investment alternatives more attractive.

The opening speech – held by the **Viennese Executive City Councillor for Housing, Housing Construction and Urban Renewal, Dr. Ludwig**, – covered the same subject-matter as Dr. Spindelegger’s presentation but with a particular focus on Vienna, a fast growing city dominated by rental housing. According to Dr. Ludwig, the City of Vienna addresses the issue of housing in different ways. The city is not only the largest landlord in Vienna but it also supports the refurbishment of existing housing and the construction of new houses by providing subsidies and land among other measures. Only projects that make for an optimal use of space, that offer high quality public spaces and that are sustainable and offer diversity get the support of the City.

The first session of the Congress discussed how asset price bubbles can be identified and prevented before they threaten financial stability. **Mr. Brinkmann, Chief Economist of the Mortgage Bankers Association in the United States**, defined price bubbles as a price increase caused by unsustainable or transitory increases in demand. Increased demand might be caused by lower barriers to homeownership, speculation, fraud, and/or an unsustainable local macroeconomic environment. Both market players and policy makers have a difficult time dealing with bubbles as the detection of a concentration of risk, speculation or fraud is not easy for an individual lender and because there is a strong policy interest in keeping the housing market growing. Mr. Brinkmann recommended that lenders should build local economic factors into credit models and that they need to increase down-payment requirements and tighten other credit requirements if they identify overheating in a local market. Regulators should support lenders in this attempt and must resist

the pressure groups (e.g. construction industry, real estate agents) that profit from the short-term expansion of real estate markets.

Mr. Kobayashi, Chief Economist, Global Markets of the Japan Housing Finance Agency, discussed the crash of the Japanese housing market at the beginning of the 1990’s and the deflationary pressures in the economy which Japan has not really escaped since then. Mr. Kobayashi’s presentation also explored the similarities and differences between the housing market crash in the United States and in Japan. In Japan, the bubble was driven by extensive lending to non-financial corporations and not by mortgages to private households as was the case in the United States. Furthermore, in the US, the Federal Reserve reacted more aggressively to the housing and financial crisis by flooding the markets with liquidity. These differences and a much better demographic outlook in comparison to Japan might help the United States to avoid the experience of Japan’s “lost decades”. However, Mr. Kobayashi also argued that a negative demographic trend is not inevitably connected with a deflationary trend. In order to avoid bubbles it is necessary that monetary policy takes also into account property markets, that it has adequate tools to tackle property bubbles and that policy-makers take more proactive approaches.

Dr. Holzhey from the UBS in Switzerland introduced the UBS Swiss Real Estate Bubble Index to the delegates. He defined a real estate bubble as a deviation of the market price from the fundamental value of the real estate, which is caused by speculative demand. However, it is, according to Dr. Holzhey, not enough to rely only on an analysis of fundamentals in order to detect bubbles. Therefore, the UBS Swiss Real Estate Bubble Index takes into account not only a fundamental but also a technical and behavioural perspective. The index is used for risk and portfolio management by UBS and other financial institutions and helps politicians and

regulators to take proactive approaches to reduce mortgage market risks.

The second session of Congress dealt with the question of how access to housing finance can be improved for markets that are so far underserved. The formal mortgage sector in developing economies is usually small but there are promising signs that the development of precisely targeted products and projects might change the current situation. This includes also focussing on those markets that mainstream mortgage finance cannot reach.

Ms. Koltsova, Deputy General Director of the Russian Agency for Housing Mortgage Lending (AHML), stated that 26 million households (ca. 43% of all households) in the Russian Federation have to live in derelict or cramped conditions. The poor condition of the housing stock is due to the fact that a large share of it was constructed prior to the 1990's and privatised thereafter – which explains also the high homeownership rate of more than 80%. However, Ms. Koltsova also explained that more than 18 million households do not have the means to improve their living conditions. The AHML, which mainly functions as a liquidity facility for mortgage originators, tries to intervene with a number of different programmes. Apart from its main business which is to support the market in order to offer competitively priced mortgages in local currency, it offers subsidies to “marginal households” or certain professional groups. Very low income groups are supported by the AHML through its Rental Housing Plan which tries to encourage the construction of professionally managed blocks of rental flats.

The presentation of **Dr. Yarza, President of the UNIAPRAVI** (Inter-American Housing Union) demonstrated that in the current decade the number of new households in Latin America will increase by nearly 50 million – who will need new homes, especially in the largest cities. Dr. Yarza argued that this huge challenge is not only a question of access to finance but also of urban planning of housing and cities. It is also about poverty reduction and upward social mobility and efficient public-private cooperation. The housing development process can be regarded as a pipeline in which the supply elements precede the demand ones. Dr. Yarza identified the biggest issue on the supply-side as the need to accommodate the high influx of new inhabitants to the cities and to avoid informal housing solutions. On the demand side it is important to develop more finance solutions for households with low and/or informal incomes. Dr. Yarza sees very promising signs here as the stable economic growth, upward social mobility and

the growth of the banking sector will support the further evolution of the demand side.

The business approach of a lender specialising in low-income customers was presented by **Mr. Mehta, the CEO of Aadhar Housing Finance in India**. Mr. Mehta showed that the market for low income groups which are usually not served by normal banks is by both numbers of potential participants and value the largest potential market segment in India. Due to their low incomes, informal employment, lack of credit history and savings and limited interaction with banks these households have no access to formal financial products. To overcome these challenges Aadhar performs an individual check on potential customers in special consultation camps where they assess their credit worthiness. If the outcome is positive Aadhar usually advises the customers on the construction of their houses and raises their financial awareness by giving financial education and providing regular mobile-based information (e.g. text messages on cell phones). It also offers convenient electronic repayment methods.

Marketing, customer confidence and sales techniques were the topics of the third session. **Mr. Pontual, Executive Director of the Brazilian Association of Real Estate Loans and Savings Companies**, gave the auditorium an insight into Brazil's remarkable economic and social success story of the last decade. With the great improvement in socioeconomic conditions, the mortgage market has also experienced a boom. Between 2004 and 2012, the volume of housing finance grew by more than 17 times. While traditional sources of mortgage finance – the Brazilian Savings and Loans System and the Employee Retirement Fund – still contribute the largest bulk of funding, new, capital market based sources of funding are on the rise. The boom in mortgage lending has been supported by banks that increasingly focus on and specialise in this market. Bank branches are widely available nationwide and teams of real estate credit specialists cater to different income segments by offering diversified products, sales approaches and facilities. By financing not only the buyers of the completed property but also the developers, most banks offer a comprehensive and integrated approach. They have lowered the costs and increased the quality of mortgage lending by cutting red tape, computerising the entire transaction process and using electronic communication with potential customers. Banks are conservative when they grant loans and they cooperate with consumer protection agencies as well as putting emphasis on financial education. Customer confidence has increased and default rates have fallen from 11.2% in 2003 to 1.8% in 2012.

Dr. Schmidinger, the CEO of the s-Bausparkasse in Austria, explained in his presentation that the Austrian housing model rests on 5 pillars:

- the system of government housing promotion,
- the legal framework (i.e. private law, building regulations, property development regulations),
- non-for-profit building associations,
- Bausparkassen (contractual saving for housing finance institutions) as well as mortgage banks, and;
- the financial industry including property investment funds.

The structure of finance for housing is a mix of different elements for both high-volume and private construction. Private buyers contribute a substantial share of own equity to the purchase process and usually combine a Bauspar loan with a normal bank loan. Sometimes they also gain access to government grants. The Bauspar institutions play an important role in the process as they help buyers to save up equity and as they are the largest providers of mortgage loans in Austria. The Bauspar contract is Austria's most popular form of saving and investment; the customers especially value the safety of the product, good returns on savings and the link between savings and entitlement to a loan. It is therefore no surprise that 60% of Austrians have a Bauspar contract and that 75% of Bauspar savers sign a new Bauspar contract once their old contract has been concluded. This success is also due to an integrated marketing concept that ranges from classic advertisements to Web 2.0 communication.

The fourth session of the Congress dealt with changes to national and international regulatory frameworks in response to the crisis. These changes were addressed by the **Financial Conduct Authority's (UK) manager of mortgage policy Ms. Blackwell** whose agency (launched 1 April 2013) is a result of the British attempts to restructure financial regulation. Ms. Blackwell thinks that more interventionist regulatory approaches which take the findings of behavioral economics into account (and do not consider lenders and borrowers to necessarily be “rational” agents) will gain in importance not only in the UK but also internationally. There will be also an increased focus on facilitating competition in the market. According to Ms. Blackwell, the FCA does not want to be prescriptive and impose restrictions on lending – that is why it refuses to use blunt instruments such as caps on loan to value, debt to income and loan to income ratios. The FCA believes that it is more important to focus on the individual assessment of affordability of loans to prevent irresponsible lending (e.g. by verifying income, stress-testing affordabil-

ity, and thoroughly checking the consumer's financial situation).

In his presentation, **Mr. Blomberg, CEO of BRFkredit in Denmark**, put the new regulatory approaches in Europe to a critical test. The financial sector is challenged by several new regulatory requirements: increased capital requirements, liquidity requirements, special rules for Systemically Important Financial Institutions (SIFI), tighter government controls, and more demanding consumer protection rules. SIFI's, for instance, will in general be required to carry more capital, be more liquid, have stricter governance and will be subject to more oversight from the regulators. According to Mr. Blomberg capital requirements for his company have doubled and the new need to hold a liquidity buffer of particularly liquid and safe assets poses an additional challenge. This is so as certain asset classes (government bonds) are privileged without good reason compared to others (e.g. Danish mortgage bonds) and this might affect certain products and portfolios which are funded with short-term bonds. Governance rules and control becomes tighter and stricter – especially the tools of the European Bank Resolution Framework, which gives regulators a lot of potential control over companies. Mr. Blomberg shares the opinion that the protection of consumers is an important good but he believes that there is an undue burden of new rules and requirements that do not serve the consumer. To the contrary, it is the consumer who has to pay the bill for the increasing cost of capital, enhanced governance and additional consumer protection. In addition the new rules might lead to consolidation amongst financial institutions and might thus affect the competitive situation.

Mr. Chimutsa, Chairman of the African Union for Housing Finance, stressed the challenges that the new regulatory rules of Basel III pose to markets that are in their infancy. In developing countries only a minority has access to the formal mortgage market and the bulk of the demand is in the entry-level, lower value market. According to Mr. Chimutsa there seems to be a trade-off between stability and access to finance. Mr. Chimutsa believes that the cost pressures from meeting increased liquidity and capital requirements will not only be passed on from the lenders to the customers but that also the increased pressure on profitability will reduce the attractiveness of smaller, entry-level loans. Furthermore, as (weaker) lenders will be forced to consolidate, market diversity is likely to decrease. As a result, Mr. Chimutsa supports the findings of a study on the South African market which suggests that Basel III could have the effect of doubling the backlogs in the entry-level

housing market. Though Mr. Chimutsa shares the view that regulatory reform is critical to safety and soundness of the banking system, it must respond to local contexts, promoting growth, innovation and inclusive markets, while supporting long term stability and consumer protection – so that the socio-economic development is not hampered.

Dr. Groszek, Vice-President of the Polish Banks Association, described the particular risks looming over the Polish mortgage market and the initiatives and regulatory measures which could be an answer to these. The Polish mortgage market which has more than quadrupled in the last nine years is characterised by an immature mortgage portfolio, a large share of foreign exchange loans in the total portfolio, a large proportion of high LTV loans, sinking collateral values, and rising default rates. As if these problems are not enough, the Polish banks are very dependent on the quality of mortgage loans due to a strong focus on this product but their refinancing structure is unsatisfactory, their experience in risk mitigation processes and the general management of large mortgage portfolios is limited, and the quality of information on property values and the credit worthiness of customers is poor. Apart from the new Basel III requirements (which only a minority of the Polish banks already conforms to) the regulator, government and Polish Banks Association have carved out several new rules and initiatives that should mitigate the risks to the Polish mortgage market. Among these are rules improving the assessment of the creditworthiness of individuals, limiting the maximum LTV ratio and demanding a continuous verification and monitoring of collateral value. Furthermore, a stabilisation fee, a new deposit guarantee scheme and the creation of an industry-wide database and credit information bureau should improve the stability of the mortgage finance system.

The fifth session directly addressed the theme of the Congress: sound housing finance – and how such a sustainable system might be constructed. Malaysia has a well-developed, stable housing finance system and according to **Mr. Chung, CEO of Cagamas Berhad**, the key elements that contributed to the sustainability are prudent involvement by the government, a strong and effective supervision of the market and the development of a secondary mortgage market. The Malaysian government facilitated the housing finance system and promotes home-ownership with different measures but it is also ready to curb house price speculation/volatility with different initiatives. The soundness and robustness of the housing finance system

lies with the strong supervision functions by the Central Bank of Malaysia which acts as the main regulator for housing finance. It is vested with comprehensive legal powers under legislation to regulate and supervise the housing finance system: it puts a special emphasis on risk management standards, corporate governance practices, and responsible lending guidelines as well as supporting the wider development of the financial infrastructure. The last element of the sound Malaysian housing finance system is an efficient secondary mortgage market in which Cagamas as provider of liquidity and hedging to mortgage lenders takes a central position. Cagamas is not only an important source of funding for the mortgage market but especially in times of crisis a crucial provider of liquidity.

Dr. Garcia, Professor at the Alberto Hurtado University, stressed the importance of appropriate macro prudential policies and supervision for stability in the housing finance system in the case of Chile. However, Dr. Garcia noted that these appropriate policies should not be limited to housing finance. Significantly, stability in the housing finance system is brought about to a considerable extent by effective economic institutions that provide for steady economic growth and reduce poverty rates. In respect of the housing market, government actions in Chile are focused on lower to middle income households in order to improve the social welfare of the most vulnerable groups. Those on higher incomes must rely solely on the market and contribute also a considerable share of their own equity if they buy a house. Furthermore, the government and regulators have supported the development of the financial infrastructure so that Chile enjoys today a robust domestic long-term credit market supported by a dynamic capital market offering a diversity of financial instruments. The Chilean bank supervisor has comprehensive legal powers; including rules that allow raising the capital requirements for larger banks and to reduce the probability of contagion from the parent company to the subsidiary in the case of foreign banks. Several other instruments recommended by Basel III (e.g. countercyclical buffers) have been already implemented in Chile for some time.

Germany had among all the OECD countries the least volatile real estate market over the last 40 years. **Mr. Schmidt, Member of the Board of Bausparkasse Schwäbisch Hall**, explored in his presentation the key elements of this exceptional period of stability. The German system is characterised by a balance between owners and renters as the rental market offers properties to suit all price/ quality segments of the rental market and rental/ fiscal laws were

able to satisfy the needs of landlords and tenants alike. The central element, however, is a prudent finance culture and sound lending practices. Mortgages usually have a fixed rate – often even for the whole duration –, borrowers contribute a considerable share of their own equity, loans are full recourse and lenders put emphasis on the ability to repay and not on the property value. The Bauspar system helps customers to save up equity for the down payment and provides also second mortgages. The government supports the equity formation as the only incentives provided for the acquisition of one's own home are tied to saving for it. First mortgages are usually issued by a normal bank. The existence of different funding channels and instruments that do not only coexist but that are integrated is also an essential element of the stable German housing finance system.

The final session revolved around the question of what the future of housing finance might look

like. **Dr. Williams from the Cambridge Centre for Housing and Planning Research** (University of Cambridge) tried to answer this question from an UK perspective. Dr. Williams explained that history and international comparison tell us that change happens in housing markets. During the last hundred years the British housing market transformed from an almost universal rental market to one dominated by owner occupiers – but this trend is beginning to reverse. The housing market is volatile, the supply weak and house prices are high (relative to earnings) and overvalued (according to studies). It therefore comes as no surprise that high LTV loans are still very common. While the British government policy was for the last few years deflationary, it has now stepped in in various ways and is committed to pumping £40 billion into the housing market over the next few years. But what lessons from the crisis can be drawn and what will the future look like? Is it more of the same or a new future? According to Dr. Williams the crisis

has shown that the quality of regulation made a difference as did the speed of response. Full recourse mortgages and no mortgage tax relief helped to reduce the scale of problem. In his opinion it is therefore very likely that we will see greater conservatism in lending practices. But this raises new questions: the barrier to home-ownership will become higher so that we will see on the one hand an increasing continuum of tenure types and on the other an increasing pressure on governments to assist “marginal households” to jump over the barrier. Another open question to which Dr. Williams pointed is the funding mix: although it is true that retail deposits and covered bonds performed better than securitised lending in the current crisis it is still difficult to tell what the perfect mix of funding would be.

All presentations are available on the congress website: www.housingfinance2013.org/en/programme/

North America - an American housing finance dilemma: what to do with Fannie Mae and Freddie Mac?

↳ By Alex Pollock, resident fellow at the American Enterprise Institute at Washington, DC

What should be done with Fannie Mae and Freddie Mac is the biggest question of the \$10 trillion, post-crisis American housing finance sector. Essentially no progress has been made on this question.

Fannie Mae and Freddie Mac were and are unique features of American housing finance compared to other countries. According to their own pre-crisis publicity, Fannie and Freddie made U.S. mortgage lending “the envy of the world.” In those days, Fannie and Freddie were accustomed to being the stars and darlings of both Washington and Wall Street – or more precisely, being a darling of Washington made them a star of Wall Street. Fannie in particular was also a greatly feared bully boy in both Washington and Wall Street, whom most politicians and bankers were afraid to cross or offend.

Perhaps drunk with the sight of power and hubris, the free use of the U.S. Treasury’s credit, and nearly unlimited command of other people’s money, domestic and international, Fannie and Freddie became major perpetrators of the housing bubble, running up the leverage of the housing finance sector, inflating house prices, escalating systemic risk, and making boodles of bad loans and investments.

As in a Greek tragedy, their hubris led to humiliation. They went utterly broke, greatly embarrassing their political cheerleaders and allies, including Senator Dodd and Congressman Frank (the chairmen of the respective Congressional banking committees), but their taste for using other people’s money did not abate. They lost all the profits they had made for the previous 35 years plus another \$150 billion. These enormous losses were foisted on the innocent public, while the government made sure that their creditors, domestic and

foreign, were paid every penny on time. Large additional losses to the public are the dead-weight bureaucratic costs of the Dodd-Frank Act, sponsored by the aforementioned former political cheerleaders.

Now the housing crisis that Fannie and Freddie made so much worse has finally ended, and the housing cycle is turning back up, as cycles inevitably do. In the mean time, the U.S. housing finance sector has become a largely nationalized and socialized “government housing complex.” As the central part of that complex, Fannie and Freddie, now owned by, run by, and simply part of the government, have attained even greater monopoly power and even more dominant market share than they had before the crisis – an ironic outcome! They have returned to reporting large profits, though they are still completely a ward of the U.S. Treasury.

Fannie and Freddie’s current large profits are completely dependent on and buttressed by:

- (a) Being guaranteed by the U.S. Treasury, that is, by the ordinary Americans who pay taxes
- (b) Being able to run with zero capital and infinite leverage
- (c) Being granted generous and indefensible regulatory loopholes by Dodd-Frank’s unfettered bureaucracy, the Consumer Financial Protection Bureau [CFPB]. The CFPB is imposing onerous and expensive “ability to pay” regulation on all private housing finance actors, but gives Fannie and Freddie a free pass, thus reinforcing the flow of business into the government.
- (d) Having the Federal Reserve buy huge amounts of Fannie and Freddie’s mortgage-backed securities--\$1 trillion and still buying-- but of course no private ones, at yields and spreads

only a central bank could love. The Fed’s mortgage buying campaign subsidizes and promotes the monopoly powers of Fannie and Freddie.

Having arrived where we are now, what should happen next?

Virtually *everybody* agrees that the United States should not return to the flawed, indeed disastrous, old “GSE” [government-sponsored enterprise] model of Fannie and Freddie before the crisis, with its warped incentives, runaway leverage, and combination of socialized risk, private profit and immense political clout. *Nobody* I know of is proposing this.

But there the consensus ends and the sharp conceptual and ideological divisions begin. Ideally, in my view, Fannie and Freddie’s current status, which no one wants, should be brought to an end with a five-year transition. What they do which is actually a mortgage business should be truly privatized (not a fake GSE “privatization” as was done with Fannie in 1968). What they do which is actually a government subsidy program should become explicitly a government subsidy program, and be merged into the operations of the Department of Housing/Federal Housing Administration [FHA]/Ginnie Mae. Fannie and Freddie would thus cease to exist as GSEs. The U.S. mortgage finance sector should move to being about 80% private and 20% government, instead of its current heavily nationalized status.

This straightforward program is not likely to be enacted in the current political configuration. Neither are any of the other numerous proposals. But should political stalemate allow Fannie and Freddie to continue their status quo indefinitely? Then as wards of the government, buttressed by the Treasury, the CFPB and the Fed, they

will continue for years to build their monopoly power and domination, probably leading us in time into a new out-of-control cycle of excessively leveraged and politicized housing finance.

Perhaps instead we could agree upon and the Congress could enact a medium-term program to move toward a more private, less government-dominated mortgage sector, without making final decisions about Fannie and Freddie's ultimate fate or role. Such a program could include the following intermediate steps:

1. Reduce the maximum size of loans that Fannie and Freddie can guarantee by 10% a year for seven years, a cumulative reduction of about 50%.
2. Continually reduce Fannie and Freddie's mortgage and investment portfolios.
3. Change Fannie and Freddie's charters from perpetual to limited life charters, with expiration and reauthorization required in 2020.
4. Put more private capital in front of the mortgage credit risk of the government. In particular, encourage credit risk retention

which is junior to Fannie and Freddie's guarantees, by high quality mortgage originators, especially by banks and savings banks.

5. Create a formal, legally binding definition of the meaning of Prime Mortgage Loan, which further stipulates that any mortgage loan which is not Prime is Nonprime. The extent of taking on Nonprime credit risk by Fannie and Freddie should be tightly monitored and limited.
6. The definition of Prime should include a counter-cyclical loan-to-value ratio (LTV)/down payment requirement based on the house price behavior in the relevant market, so that soaring house prices automatically trigger lower LTVs and higher down payments in order to qualify as Prime.
7. Increase the role of local mortgage lenders by authorizing Federal Home Loan Banks to securitize Prime Mortgage Loans which are all credit enhanced by their member banks and savings banks.
8. Enact U.S. covered bond legislation.
9. Entirely close the giant loopholes created by the CFPB for Fannie and Freddie (and for

the FHA). If the CFPB has defined valuable consumer protections in its regulations, such protections should apply to all mortgages, without exception.

10. Stop the Federal Reserve from buying any more Fannie and Freddie MBS, so the MBS market can clear, rather than being heavily manipulated by the monetization of mortgages. The housing cycle is definitely rising once again; there is no excuse for the Fed to continue subsidizing the market dominance of Fannie and Freddie.

With such an intermediate program, the U.S. private mortgage market could gain market share, while the share of the nationalized Fannie and Freddie would be reduced. We do not have to know in advance exactly how large this healthy shift would ultimately be. The U.S. can start moving seriously in what virtually everybody agrees is the right direction.

However, the politics of this American housing finance dilemma will not be easily settled. Stay tuned.

Housing finance in Latin America in 2013

↳ By Ronald A. Sanchez Castro

The housing finance sector in the LAC-5 [Brazil, Chile, Colombia, Mexico and Peru], is an important sector of the economies of those countries. It is performing dynamically in Brazil and Chile, while in Peru it is growing, but moderately. In Colombia the Government is seeking to boost this sector. In Mexico the housing finance sector started this year with greater strength but there is a worrying lack of liquidity and excess of debt amongst Mexico's largest homebuilders.

In Brazil, the Brazilian Association of Entities of Real Estate Loan and Savings [Abecip] has indicated that in 2013 there is still a growing trend in housing finance. In January it grew 17.5%, in February 13.7% and March 15.9%. In the first quarter of 2013 the value of loans grew 15.8% with a disbursement of R\$ 20.4 billion. Caixa Economica Federal [CEF] reached a new record in home loans nationwide with a total of R\$ 28,91 billion disbursed in the first quarter, and is looking to finish 2013 with R\$ 126 billion of lending. Also the Brazilian Federation of Banks [Febraban] indicates that default rates fell for the second time, to 3.43%, after five quarters of increase.

In Chile, according to the Central Bank, the interest rates on loans over three years in UF [housing loans] in the first months of this year reached 4.43% in January, 4.53% in February and 4.53%

in March; however, the industry is still dynamic and the Superintendency of Banks and Financial Institutions [Sbif], has determined that the mortgage loans had continuous growth levels over the same period last year of 9.23%, 9.36% and 9.47% in January, February and March, respectively. Also, the default periods of 90 days or more were stable at 3.79%, 3.78% and 3.75% for January, February and March respectively.

In Peru, according to the Central Bank mortgage growth rates seen in the early years have moderated, so that growth rates were 1.33%, 0.87% and 1.56% compared to the same period last year for January, February and March respectively. This fact is explained by the macro-prudential policy measures imposed by the Central Bank and Superintendency of Banks and Insurance. The amount of mortgage credit increased to S/. 24.288 million at the end of February, and also showed a further decrease in dollarization of mortgages as only 45.16% are now in dollars. Default rates were stable at between 0.8% and 0.9% which are the lowest in the Region.

In Colombia, the role of the Central Government has been highlighted by it providing more facilities for the purchase of homes. The ceiling for subsidy of up to 12'969,000 pesos for Social Housing was raised by decree and the Housing

Ministry initiated a second program of 100,000 free homes; and through the Plan to Enhance Productivity and Employment, the Government and the banking sector agreed to reduce interest rates for housing loans from 12.5% to 7%. The cost of lowering interest rates by five percentage points will be assumed by the banking sector and the Government equally.

In Mexico, according to the Mexican Mortgage Association, mortgage loans started the year 2013 with greater strength. In January 2013 lending stood at 15.6 million pesos that is 28% more than for the same period in 2012. The National Housing Commission [Conavi] reported that housing agencies in the first two months of this year placed 3,098 million in mortgage-backed bonds that is 37 percent less than in the same period of 2012. While the Institute of the National Housing Fund for Workers [Infonavit] issued Trust Bonds for the amount of 3 billion pesos, which will pay a rate of 3.3%. In March the government launched a new program of "home builders' guarantees" for up to 15,000 pesos (1,180 million dollars) for this year, which are intended to provide liquidity to the sector. However, in April the listings of the five largest homebuilders in Mexico plummeted on the Mexican Stock Exchange [BMV], due to lack of liquidity and billions of pesos of debt.

The super-rich and the globalisation of prime housing markets

↳ By Chris Paris

Residential real estate is a tale of two markets – luxury and everything else.

(Christie's 2013: 1)

1. Introduction

The core argument of this paper is that growing disparities in wealth and income, combined with the explosive growth of the fortunes of the super-rich and their purchases of prime residential real estate, are dramatically changing relationships within and between global cities resulting in the evolution of a transnational system of prime residential property (Paris 2012, 2013a). Diverse sources show that hyper-mobile super-rich individuals and families purchase and use numerous homes in many locations across the globe with complex spatial inter-relationships between countries of residence and ownership of residential properties. Super-rich households own homes in many global cities, especially London, where overseas buyers of luxury homes in prime locations contribute to a de-coupling of prime residential housing from the dynamics of the wider UK housing system.

Social scientists specialising in housing have been slow to appreciate the significance of the globalisation of finance markets in relation to housing investment and consumption, though real estate industry experts are well aware of such developments (Barkham, 2012; Knight Frank, 2011a). Many social scientists have examined growing disparities in wealth and income nationally and internationally, but Beaverstock et al (2004) noted their tendency to focus on the consequences for the poor whilst ignoring the significance of growing numbers

and affluence of the very rich. More recently, geographers have begun exploring the new geographies of the super-rich, including their significance in reshaping places in global cities and regions (Hay and Muller 2011; Hay 2013). These authors emphasise how inequalities in income and wealth have increased dramatically in many countries over the last 15 years (Short 2013; see also OECD, 2011), with growing gaps between the very rich and everyone else, and a changing global geography of affluence. Growth in the number of billionaires in former communist and less-developed countries has been especially rapid, notably China, Russia, India and Brazil [the 'BRICs'] whose recent combined annual GDP growth alone was estimated by Knight Frank (2013: 3) to be 'equivalent to the creation of a new economy the size of Italy each year'.

2. Deregulation, globalisation and the rise of the global super-rich

Globalisation of economic relations and the deregulation of financial markets have transformed the nature of housing markets and housing finance. Deregulation unleashed new financial and organisational processes that complemented the accelerating globalisation of production and consumption relations after the fall of the Berlin Wall in 1989. Combined with political change in former communist

states, deregulation and globalisation enabled the transfer of former state instrumentalities and assets into private individual and corporate ownership, resulting in a rapid increase in the number of billionaires. This was especially the case in Russia, which has the highest ratio of billionaires relative to population size, and the rapid marketisation of notionally socialist China (Freeland, 2012).

The global super-rich, sometimes described as high net worth individuals [HNWIs] or ultra-HNWIs (even richer), are identified in regularly published lists, especially *Forbes* magazine and *The Sunday Times* Rich List. *Forbes* magazine lists are freely available online whereas *The Sunday Times* is only available electronically by subscription (though Wikipedia reports the top UK fortunes). These lists and other electronic sources provide detailed information on super-rich individuals and families, the sources of their wealth, and their homes (Paris 2013). Other evidence about their investments in residential property derives from industry and media sources, with research and commentary by many financial institutions and organisations, and housing market organisations especially global estate agents Knight Frank, Savills, and Christie's, whose publications shed light on what they and their clients think and do. Four themes stand out: HNWIs are globally-oriented people who live and work in many locations; particular cities are more important than their host countries of their location; political stability and

transparency of commercial and legal systems are key factors affecting residential purchase decisions; and, they typically own *many* homes in diverse locations (Christie's 2013; Freeland 2012; Savills 2012).

Many of the contemporary super-rich have acquired their fortunes rapidly through their own work in industry, especially new ICT and related sectors, finance and new technologies. The classic ways of becoming rich in pre-industrial societies were royal birth, imperial patronage, colonialism and/or military conquest and plunder (Beresford and Rubenstein, 2007). Such sources of wealth are much less prominent in recent rich lists, though inheritance still figures strongly in Europe and North America, and the origins of many contemporary fortunes were not entirely unlike plunder, including the privatisation of former state instrumentalities and assets, especially minerals and telecommunications, in post-communist countries as well as developing counties including India and Mexico (Freeland, 2012). Unlike the richest households and dynasties of pre-industrial Europe, the 21st century super-rich have almost unlimited mobility, typically in their own or chartered airplanes or first class cabins of premier airlines. They own many dwellings in numerous countries as well as luxury yachts and country estates (see figure 1). They can both take their pick of additional homes in many locations and also effectively chose their nominal country of residence.

The most rapid increase in the numbers of billionaires has been in Russia and China, and these in turn are playing major roles in transforming transnational housing markets. Moreno (2012) identified many similarities between super-rich Russians and Chinese in contrast to longer-established North American or European HNMs. Neither country had any billionaires before the 1990s but their numerical growth has been extremely rapid, their average age was 15 years less than American or German billionaires, and they had among the highest levels of self-made fortunes (100% in Russia and 83% in China compared to 43% in France and 33% in Germany). Both countries' billionaires tended to be 'lone wolves', with low rates of family involvement in asset management, as well as relatively high numbers of self-made women among the ranks of billionaires, especially China. Moreno also argued there was little philanthropic giving in Russia or China; this contrasts sharply with the USA where many of the richest are energetic philanthropists, especially Bill Gates and Warren Buffet. Super-rich Russians are already well-established purchasers of prime residential properties in London and New York whereas the impact of HNW Chinese purchasers of overseas

Figure 1: Some of the many homes of the global super-rich



Clockwise from top left: John Travolta's home-cum-airport, One Hyde Park, Antilla (Mumbai), one of Roman Abramovich's yachts, Bill Gates residence, one of Lakshmi Mittal's homes in London.

Source: collage prepared by Scott Johnson for use by Chris Paris in scholarly publications.

prime property has come later, but is growing and likely to have even greater impacts on these cities as well as Vancouver, Melbourne and Sydney in the Pacific region (Rapoza 2011).

The globalisation of economic relations has been accompanied by rapid growth of transnational investment in housing (Paris 2011, 2012). The purchase and sale of many homes by the global super-rich is largely unrecorded within national statistics on housing finance and the idea of 'national' housing markets has become increasingly problematic. National housing markets may exist in the form of aggregates of statistics collected by national governments or private agencies operating within particular jurisdictions, but these collections rarely include *all* housing transactions within states or identify transnational sales and purchase of dwellings. Various national accounts and statistical col-

lections refer to 'housing finance' but these typically refer to the purchase of dwellings using mortgages or loans. For example, tables on the private housing market UK in the *UK Housing Review 2013* are based on data about dwellings purchased using mortgages or loans; comparisons between countries are made on the basis of the same kinds of data (for example, by EU and OECD analysts). Thus while 'housing finance' in the UK typically refers to data about such transactions, this definition excludes the financing of housing by and for people who do not use regulated loans derived from within the country or housing that is purchased by or through companies (and cannot account for property that is inherited). This is especially pertinent to prime residential real estate, because 'the higher the price of the property, the less likely buyers were to arrange traditional mortgage financing for the home acquisition. Whether buyers are foreign or

Figure 2: The diverse attractions of global locations for super-rich homes

WHERE THE WEALTHY WANT TO BUY AND MOVE TO

The network of international prime property sales is becoming increasingly complex. Our Attitudes Survey asked wealth advisers where their clients were considering buying a second home or relocating to permanently. Our map reflects the activity.

SECOND-HOME PURCHASES

Where the wealthy from different parts of the world buy second homes

NORTH AMERICA %	
France	17
Mexico	12
United Kingdom	9
United States	8
Italy	7
Canada	7
Costa Rica	6
Hong Kong	4
New Zealand	4
Bahamas	4
Bermuda	4
Australia	3
Ireland	2
China	2
Nicaragua	2
Panama	1
St Kitts and Nevis	1
Brazil	1
Belgium	1
Spain	1
Monaco	1
Argentina	1
Virgin Islands	1
St Lucia	1
Malta	1
Jamaica	1
Chile	1

LATIN AMERICA %	
United States	48
Spain	18
France	13
United Kingdom	8
Canada	3
Argentina	3
Switzerland	2
Bahamas	2
Panama	2

EUROPE %	
United Kingdom	28
France	24
United States	18
Switzerland	12
Spain	9
Monaco	4
United Arab Emirates	2
Italy	1
Thailand	1
Guernsey	1
Barbados	1

RUSSIA & CIS %	
France	42
United Kingdom	25
Italy	25
Monaco	8

MIDDLE EAST	
United Kingdom	
France	
United States	
Lebanon	
Switzerland	
Morocco	
Spain	

CHANGING COUNTRY OF RESIDENCE

Where the wealthy from different parts of the world want to relocate their principal residence

NORTH AMERICA %	
Canada	10
Switzerland	9
United Kingdom	8
France	7
Mexico	6
New Zealand	6
Cayman Islands	6
Bermuda	5
Bahamas	5
China	5
Australia	5
Italy	5
Barbados	3
United States	3
Hong Kong	3
Ireland	2
Chile	2
Germany	2
Jersey	1
Costa Rica	1
Macao	1
Isle Of Man	1
Antigua & Barbuda	1
Monaco	1
Spain	1
Austria	1
Argentina	1
Finland	1
Anguilla	1

LATIN AMERICA %	
United States	47
Spain	15
Canada	12
United Kingdom	8
France	5
Portugal	5
Switzerland	3
Panama	3
Colombia	2

EUROPE %	
Switzerland	39
United Kingdom	12
Monaco	9
United States	8
Singapore	4
Hong Kong	4
France	3
Bahamas	3
Belgium	3
Guernsey	3
Jersey	3
India	3
Canada	2
United Arab Emirates	2
Spain	1
Bulgaria	1

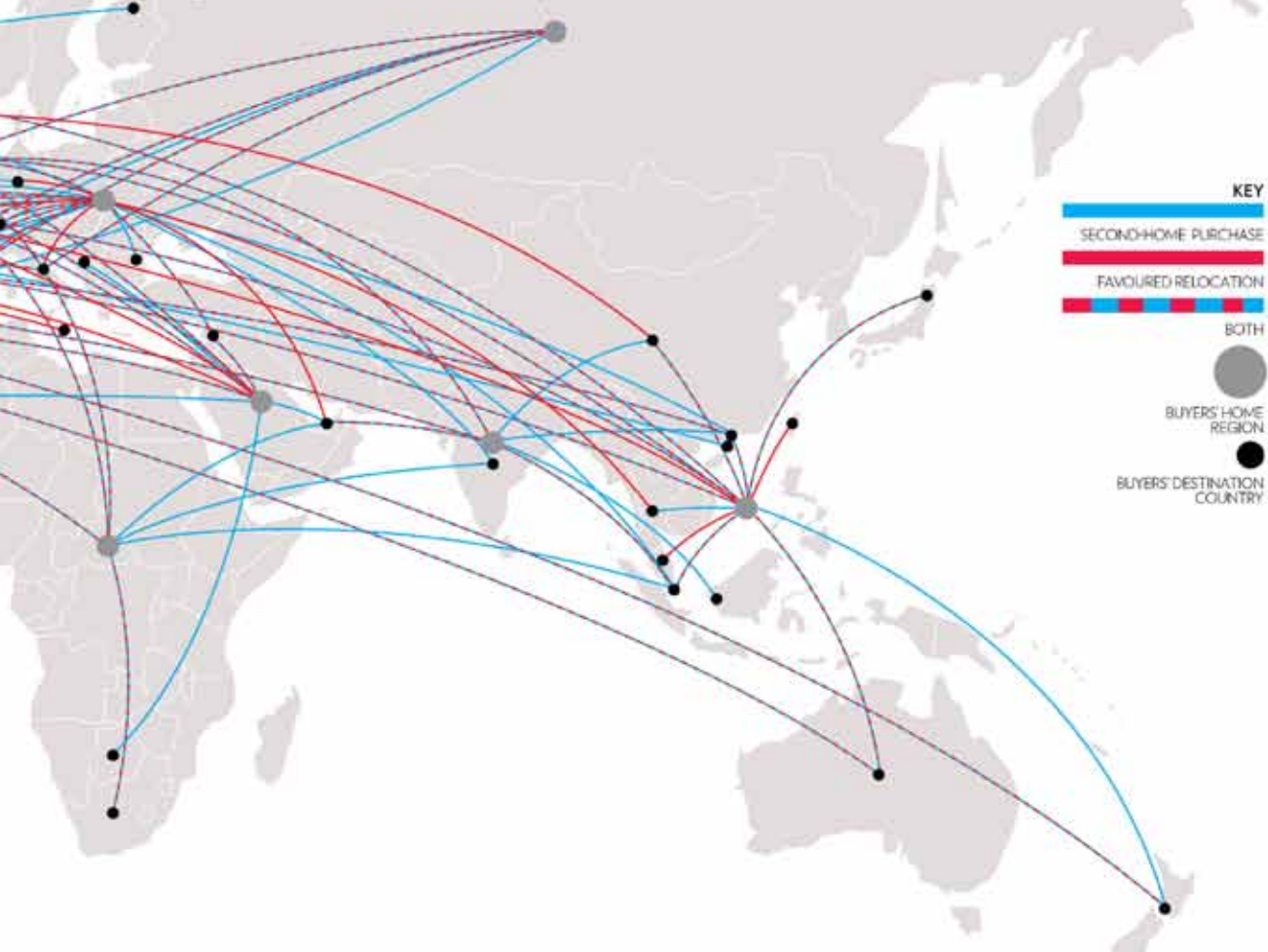
RUSSIA & CIS %	
Monaco	25
France	25
Switzerland	17
Italy	17
United Kingdom	8
Spain	8

MIDDLE EAST	
United Kingdom	
Lebanon	
United States	
United Arab Emirates	
Switzerland	
Belize	
France	
Bosnia & Herzegovina	
Botswana	

Source: Knight Frank 2011a; reproduced with permission from Knight Frank.



AFRICA		INDIA		EAST ASIA	
96	United Kingdom	96	United Kingdom	96	United States
43	United States	50	Singapore	19	Singapore
18	France	33	United States	16	China
15	South Africa	8	United Arab Emirates	14	Canada
10		8		13	United Kingdom
6		8		12	Australia
3				11	Hong Kong
2				7	Japan
				4	Taiwan
				3	France
				1	Switzerland
				1	Malaysia



KEY

- SECOND-HOME PURCHASE
- FAVoured RELOCATION
- BOTH
- BUYERS HOME REGION
- BUYERS DESTINATION COUNTRY

AFRICA		INDIA		EAST ASIA	
96	United Kingdom	96	Singapore	96	Singapore
40	United Arab Emirates	25	United Kingdom	22	Canada
18	United States	25	United Arab Emirates	17	Australia
13	Singapore	17	United States	17	China
8	South Africa	10	Indonesia	14	United States
7	India	4	Hong Kong	11	Hong Kong
5		2	China	9	United Kingdom
3		2		3	Switzerland
2		2		2	France
		2		1	Japan
		2		1	New Zealand
		2		1	Thailand

For more Attitudes Survey results, and to find out which global locations should be on investors' radars, see *Databank* on p60

domestic, cash transactions predominate at the higher end of the market' (Christie's 2012: 14).

Most housing analysts treat 'housing markets' as interactions within nation states and ignore transnational and global dimensions of housing markets, but residential investment decisions by the super-rich have *huge* impacts on prime real estate in cities and regions across the globe. Sassen (2006:10) argued that the emergence of an international property market 'means that real estate prices at the centre of New York City are more connected to prices in central London or Frankfurt than to the overall real estate market in New York's metropolitan areas'. Leading real estate agencies operating at the top end of the housing market are well aware of these developments and play key roles in servicing the requirements of super-rich investors and their purchase of many homes in global cities and leisure regions (Cousin & Chauvin 2013; Paris, 2013). Their market analyses and marketing activities together provide ample documentation of the dynamic nature of the international real estate market and the varying positions of different cities and regions. Critically, global luxury real estate is almost entirely insulated from developments in 'national' housing markets, as Savills and Christie's point out:

- Billionaires pay money for real estate in world-class markets quite independently from the national residential markets in which they sit (Savills 2012: 18).
- The luxury housing market remains insulated from money flows and political shifts, as these concerns are less likely to determine the purchase of a trophy home for the ultra-high-net-worth population around the globe. (Christie's 2012: 18)

The super-rich can be considered as 'transnational' because most share a global rather than national orientation, regarding both their business interests and leisure pursuits (Beaverstock *et al* 2004; Freeland 2012) They are hyper-mobile and 'most of the super-rich have multiple residences' *op cit* (404) but they invest and consume in *particular* places, whether prime areas of global cities or exclusive, iconic leisure locales including places like St Barts and the French Riviera, and indulge in hyper-consumptive leisure practices.

3. The many homes of the global super-rich

Residential property is a key element in the investment portfolios of the global super-rich, both for private use through luxury consumption

of trophy homes *and* as investment items with anticipated long-term capital gain, often untaxed as the properties are owned by companies rather than individuals. Hyper-mobile super-rich individuals and families own and use *many* homes in several locations, with complex inter-relationships between countries of residence and ownership. They own residences in global cities, high end resorts and remote fortified estates. Many choose residential bases to minimise tax obligations, notably Monaco.

The trophy homes of the global super-rich share many characteristics with valuable up-market works of art and are in many ways the same thing: scarce objects with high value consumption characteristics plus real asset value growth over time, especially with growing numbers of the super-rich and restricted supply of space and art (even given the productivity of Damien Hurst). Christie's International Real Estate makes this connection explicitly:

As the only real estate network owned by a fine-art auction house, Christie's International Real Estate has unparalleled access to the HNWI's around the globe who procure assets such as art, wine, jewelry, and, of course, real estate...Location, lifestyle, and provenance, particularly at the top end of the luxury residential real estate market, are the hallmarks of value and often equally as important as price when HNWI's consider a property purchase (Christie's 2013: 3)

Unlike the homes of the vast majority of owner-occupiers whose purchases are recorded in national housing finance statistics, most trophy homes are rarely if ever dwelt in by their owners. Savills (2013) argued that many overseas purchasers of ultra-prime homes in London do intend to use them as primary residences; but this means by definition that their *other* residences will be used much less often. Trophy homes are depositories of assets, access points to occasional residence within the city/country for leisure or business trips, and potential bolt

holes should changing circumstances in other countries result in their owners wanting to get away quickly. They are also bases for citizenship tourism and purchase of rights to residence through property purchase, with their purchasers able easily to enter the USA, Australia or the UK. Knight Frank (2011a) showed the complex and significantly different patterns of purchase of second (3rd, 4th etc) homes for residence, on the one hand, and for use as a base for primary residential location (figure 2 on next page).

Knight Frank (2010) conducted and reported on a study of the global 'cross-border, non-domestic, luxury residential market'. They surveyed 350 wealth and property professionals in 33 countries, working mainly in banking, real estate, financial and legal services. They identified the main factors motivating purchasers of luxury housing, the origins of purchasers and where they were buying, and assessed likely future trends within this numerically small but extraordinarily valuable sector of housing markets. The main factors affecting purchase decisions were lifestyle, security and investment (60%). Other factors including business, tax and education were relatively less important, though many purchase decisions reflect *combinations* of factors. Although the factors and combinations can change rapidly, in 2010 some patterns were identified regarding cities' relative attraction in terms of different factors (see figure 3).

Most future demand for prime homes was expected to focus on 'mature established regions', mainly in countries with stable governments, and to come from all world regions. Demand was expected to be very strong in high end European sun and snow resort and leisure areas (Alps, French Riviera), and for homes in low tax jurisdictions (Monaco, Channel Islands, Switzerland, Dubai and some Caribbean nations). The high value placed on political stability recurs throughout expert commentary on transnational purchase of prime residential property, especially in countries that were seen to be 'safe havens' for investment.

Figure 3: The diverse attractions of global locations for super-rich homes

Education	London, Boston, Zurich, Hong Kong and Singapore
Business	New York, London, Shanghai, Sydney and Hong Kong
Tax	Grand Cayman, UK Channel Islands, Zurich, Singapore and Monaco
Lifestyle	St Moritz, London, Paris, Cap Ferrat and Algarve
Security	Monaco, Geneva, Zurich, Singapore and UK Channel Islands
Investment	Cape Town, Abu Dhabi, Hong Kong, Sydney and London

Source: Knight Frank, 2010

Following the economic downturn, Miami, London and New York came to epitomise the so-called safe haven market, with overseas buyers looking to escape currency, economic, political and security crises by putting equity into tangible assets that appeared safe from government sequestration so global capital flows continue to concentrate on a few key hubs (Knight Frank 2013a: 2).

Other studies have identified strong demand for exclusive leisure activities, especially conspicuous consumption of extensive leisure-related properties in the 'elite countryside' (Woods, 2013), often in areas associated with horse racing and polo (Roberts and Schein, 2013; McManus, 2013). The leisure theme is explored in Savills (2012) *World Cities Review* which included a section on global leisure properties for the super-rich residents of its ten 'world cities'¹ from which 'limousines and Lear jets make the weekend escape easy', with fascinating contrasts between the modes of travel to favoured leisure locations. Limousines enabled super-rich Muscovites, Londoners and New Yorkers to get to Razoory, Oxfordshire, and the Hamptons, but their counterparts from Shanghai and Hong Kong were more likely to use jet planes, in both cases to get to Phuket.

Purchases of luxury residential property reported in the Knight Frank (2010) survey took place mainly *within* some regions, especially Russia/CIS, South America and the Middle East. By way of contrast, the origins of the super-rich buyers of European and Caribbean property were more diverse, with high proportions from the USA and Canada and strong and growing involvement of Asian buyers. Asian HNWIs were also active in Africa, Europe, the Middle East and North America. Anticipated future demand was significantly different in terms of the origins of buyers than the situation reported in 2010. The strongest growth relatively was expected from South America and Africa, albeit from low bases. Much lower growth in demand was expected from other regions, including Europe and North America. By far the greatest volume of anticipated demand growth, however, was from Asia, which even in 2010 was *already* high. More recently, Knight Frank (2013a) has remarked on 'the widening demand for luxury property', as 'the real story of 2012 was the rise of demand from China' both in the UK, essentially London, and the USA, where the Russians are particularly attracted to Miami as well as New York.

One of the attractions of prime residential areas of London and New York, in addition to their role as safe havens, is the scarcity of land and severe supply constraints. They are not only 'safe' places to store assets, but 'demand is ever rising while the stock of desirable locations remains virtually static, and so global capital flows continue to concentrate on a few key hubs' (Knight Frank 2013b: 4). Constraints on supply are *good* things for super-rich buyers, because trophy homes benefit as positional goods (Freeland, 2012). Restricted supply sustains and enhances current values of land and housing, as in Sydney, where 'underlying restrictions of land availability, due to zoning regulations and limited land release, ensure that land values, and in turn house prices, remain the highest in the country' (Savills 2012: 12). Thus planning restrictions on land supply or new development only *add* to the lustre of existing dwellings or new prestige developments that do get approved.

Recent commentary on prime global residential property markets has identified diversity and differences between cities and regions. For example, Knight Frank (2013) argued that 'mainstream' middle class housing markets had out-performed prime residential properties in many Asian countries, partly due to growing demand generated by the spectacular growth in absolute numbers of middle class home buyers. As well, many Asian super-rich households were more inclined to invest in prime global property markets 'outside their domestic arena'.

With an increasingly mobile, educated and well-travelled class of property owners in the Asian region, the lifestyle choice of having a second home abroad, for personal or children's educational use is proving to be one of the key narratives for HNW Asian buyers. Purely from an investment point of view, as a diversifier away from the steamy and controlled Asian markets, it has been seen as a sensible strategy for their wealth portfolios (Knight Frank 2013b: 4)

Globalisation and deregulation have been accompanied by ever faster and easier movement of capital; expensive labour in developed countries and regions can easily be replaced by cheaper labour elsewhere, but land remains relatively fixed. Particular sites, moreover, take on additional value due to location in the cultural cores of 'safe haven' cities and desirable exclusive leisure locales, with their investments given added pro-

tection by restrictive and exclusionary planning and zoning regulations.

4. London: the second homes capital of the world, decoupled from the UK?

Last year the Council of Mortgage Lenders [CML] suggested that London was 'akin to an autonomous city-state, quite dissimilar to the rest of the UK' (CML 2012). In response to its own question 'what's different about the London market?' it noted that London was a global city, but attributed most of its distinctive housing market features to domestic factors and even governance arrangements. But it said nothing about the possible impacts of non-domestic residential property ownership, in sharp contrast to real estate industry sources which have no doubts about the crucial role played by overseas buyers contributing to strong house price growth in London.

In 2011 and 2012 overseas buyers accounted for one third of buyers of all prime London property and 59% in central London (78% in the new build markets over £5 million). (Savills 2013: 8)

Heywood (2012) has remarked on the rapid growth of overseas investment into London after 2007, especially into the new-build market with a heavy concentration in Westminster and Kensington & Chelsea. He argued that increased foreign investment was boosting the prime real estate market in inner London and adding to its growing divergence from property price trends with the rest of London.

London has it all for global HNWIs buying trophy homes: political stability, commercial transparency, clear property title, vast cultural resources including schools and universities; and recently the pound's weakness has coincided with concerns about other financial instruments thus helping to boost demand even further (Knight Frank 2013: 2). These factors are complemented and enhanced by the most rigorously restrictive planning regime in the world. A classic rationale for town and country planning is that it is in the 'public interest' to manage land use across the whole country. In the UK, however, this has clear parallels with the concept of 'public' schools in the 18th century sense: i.e. 'public' as opposed to the private tutors of the aristocracy. Today,

¹ New York, London, Paris, Moscow, Mumbai, Singapore, Shanghai, Sydney, Hong Kong and Tokyo.

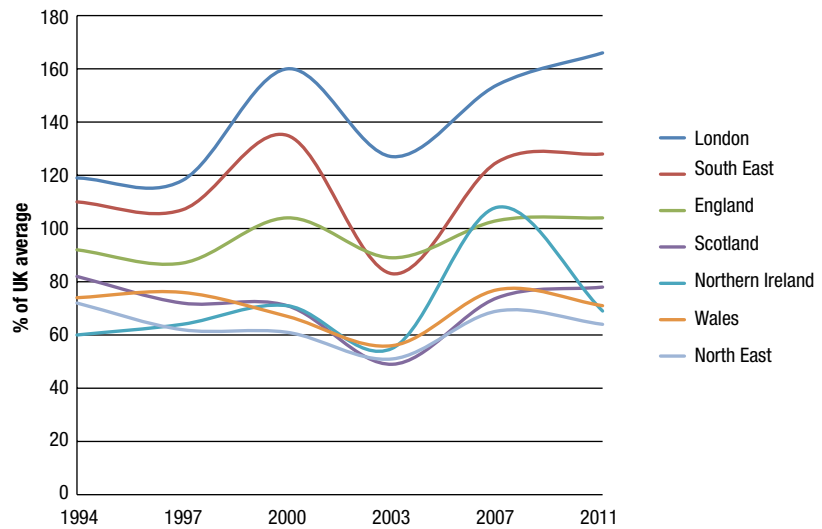
both 'public' schools and planning in the 'public interest' serve the needs of an elite 'public' that is already highly privileged and asset rich, including aristocratic owners of vast acreages of the British countryside, and increasingly a wider global super-rich 'public' bringing its wealth and power into the UK from overseas.

House price indicators from *The Economist* interactive website, the OECD (2012), European Union data sets and the European Mortgage Federation statistical analyses, 'Hypostat' show diverse international house price trends since the GFC in 2007-08, but none of the national trends bear any observable relationships with the trends in prime residential properties in global cities within those countries, based on data available from major global real estate agencies. Nothing distinguishes house price developments in Britain or the USA from the pack of countries where prices fell after 2007 and then recovered slightly through to 2012. Why is price growth of prime properties in some global cities stronger than in the countries within which they are located or the price growth of residential property in other global cities? The only credible answer is that the price of prime property in these countries bears no relationship to national house price trends, confirming the claims of the major real estate agencies that there is a quite separate and distinct global market for prime real estate in certain cities, especially safe haven London and New York.

Prime residential property in these cities is decoupled from national and even metropolitan regional developments: '....there is no escaping the fact that the prime London sales market has decoupled from the wider UK residential market and economy. (Knight Frank 2011: 2). Even the London prime residential market was affected by the GFC, with prices falling in 2008, but since then it has continued to boom. The sale of £1m-plus homes surged in Britain from 2010, with over 80 per cent located in London and SE England (Lloyds TSB, 2011). Overall, the price of London's prime residential properties, defined as the top 5% of the mainstream market by value, was estimated by Knight Frank (2013) to have increased by 57% between 2009 and 2013. This stellar increase in prime London house prices stands in sharp contrast with overall house price trends in Britain: *The Economist* interactive house price indices showed a net loss of nearly 20% for all British house prices between Q1 2006 and Q3 2012.

How much can we measure the effects of decoupling? We have noted that national data on house prices rarely record property acquisitions by non-domestic or corporate purchasers and that national data on house prices conflate such variations at regional and local levels, thus

Figure 4 Average house prices UK countries and selected regions, 1994-2011



Expressed as a percentage of UK average prices, based on all dwellings

Source: Derived from Department for Communities and Local Government Live Table 507, <http://www.communities.gov.uk>, accessed 20 May 2013.

'average prices are becoming increasingly meaningless and conceal a huge range of different experiences' (Savills, 2012b). Our first step is to disaggregate regional and local house prices and compare developments in London with other regions (see figures 4 and 5). Regional variations can be clearly demonstrated across the UK on the basis of official housing data, freely available in live tables from the Department for Communities and Local Government [DCLG] and the *UK Housing Review 2013*. The second step in our attempt to derive a measure of the impact of decoupling is to examine more local level house price variations, especially within London, using the Land Registry house price index to fine tune the analysis. The Land Registry index uses a 'repeat sales' regression methodology observing actual transactions, comparing like with like over time, with all recorded residential property transactions regardless of the sources of finance used for purchases. It has details of over 17 million sales with six million identifiable matched pairs. Like other official sources, however, it cannot record covert sales nor can it record gifts and inheritance. Thirdly, we consider the value of residential property across all English cities to get a handle on the dimensions of de-coupling within London.

Figure 4 is derived from government mix-adjusted house price statistics, thus it excludes the impact of externally-funded and cash-purchased dwellings. It shows average regional house prices as

a percentage of average UK prices for the four UK countries as well as London, the South East (the next strongest house prices), and the North East (the weakest English house price region). House prices in England remained considerably higher than in Scotland, Wales or Northern Ireland since the early 1990s, except for a brief speculative boom in Northern Ireland between 2003 and 2007. Figure 2 also shows *growing* regional gaps, as prices in London and to a lesser extent South East England pull further away from other UK regions, especially the depressed North East. House prices fell across the UK after 2007, before recovering slightly in 2009 and remained flat overall since 2010, except in Northern Ireland where they continued to fall. London house prices recovered more strongly than other regions and have drawn away from the rest of the country since 2011.

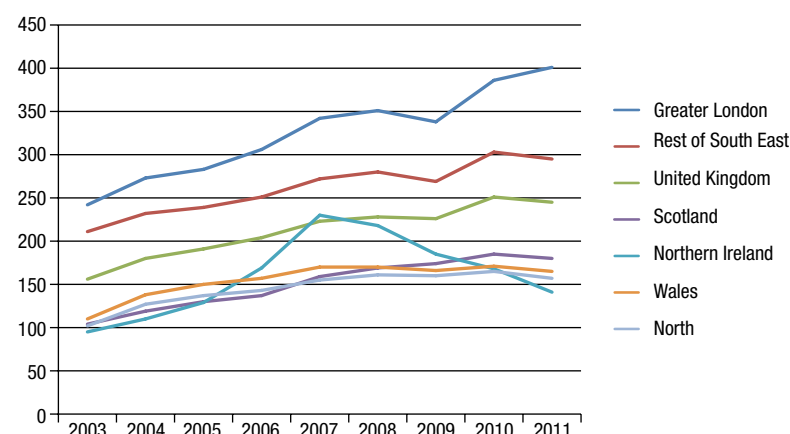
A similar pattern emerges from an examination of actual house prices in the *UK Housing Review 2013*, based on the sales of homes purchased using mortgages or loans (including owner occupiers and landlord investors). As with figure 4, this indicates strong differences between London and the rest of the UK, especially as data for London are included within the UK average. It also highlights how Greater London house prices have been pulling further away even from the rest of the South East.

The UK Land Registry house price index showed falls at the county level across the whole of England in 2010 and 2011 (Land Registry, 2011), with the exception of Greater London, where prices rose by one per cent, and two southern coastal areas. More recently the Land Registry (2013) has shown that London prices increased overall by 9% during 2012 with a general south-north gradient in house price changes across England, with annual increases around 1% in the East, South East, South West (and in Wales), a slight increase in the West Midlands, slight falls in Yorkshire & The Humber and the East Midlands but much larger falls in the North East (-5.5%) and North West (-4.9%).

Prices in some inner London Boroughs increased *much more rapidly* than in London as a whole during 2011 and 2012. Whereas London house prices increased overall by 1% in 2011, they increased by 7% in the City of Westminster and 5 to 6% in Islington, Kensington & Chelsea, and Hammersmith & Fulham. The same boroughs also scored highly in 2012, especially Hammersmith & Fulham (13%) as also did Camden, Wandsworth, Hackney and Haringey (9-11%). Average house prices climbed above £1.1 million in Kensington & Chelsea, followed by The City of Westminster (£770,000), Camden (£652,000) and Islington (£499,000). The boroughs of Barking & Dagenham (£214,000) and Newham (£231,000) lay at the other end of the London price spectrum, but even they had average house prices around or over *twice* the level of midlands and northern English regions or in Wales.

There is nothing particularly new about London having higher house prices than the rest of the UK, but the scale of differences has become significantly greater during the period since the GFC. The overall effect in terms of the variation in the asset value of residential property is staggering. The leading UK residential valuation company, Hometrack, has an extensive data base of residential real estate transactions across the country. It provides information, analyses and advice to mortgage lenders, house builders and leading housing associations as well as local authorities and other government agencies. It used its extensive database to produce a special analysis of property values in 64 British cities for *The Guardian* newspaper in March 2012 (Collinson 2012). The spatial areas of the cities were delineated on the basis of individual

Figure 5 Average regional house prices 2003-2011 (£000)



Source: UK Housing Review 2013 Table 47b

and amalgamated local authority areas called primary urban areas (PUAs) as defined in the State of the English Cities reports (for example, Turok et al 2006).

On that basis, the 3.7 million addresses in London were valued at £1,365 billion, with an average value of nearly £370,000. London property was valued at about the same as the next 40 PUAs combined, containing over 8 million addresses. The data show a marked gradient from south to north, with the next 9 most valuable PUAs all in southern England, with average prices topped by Oxford (£344,000) and Cambridge (£314,000). The only northern PUAs in the top 20 by average residential property value were York (£206,000) Edinburgh (£201,000) and Aberdeen (£179,000). Hometrack is developing a methodology for assessing the extent of house price recovery since the GFC². This shows that London, Oxford and Cambridge have outpaced the rest of the UK in house price recovery, with prices up by 25-30% of the 2007 peak. The only other places to be at or above the 2007 peak are all in the south: Brighton, Reading and Crawley. But London's recovery has been highly differentiated: the top 25% of the market has grown by 35-40% whereas the bottom 25% is still *below* the 2007 peak in late 2012.

The evidence and analysis here strongly confirms the massive and increasing dominance of UK house prices by London. When combined with

clear evidence of growing differentials between London and the rest of the UK, plus the Land Registry data showing massive differentials within London, the Hometrack evidence supports the arguments of the real estate industry analysts and Heywood (2012) that London house prices overall have been massively boosted by strong growth in prime inner city areas accentuated by massive inflows of overseas investment.

Such variations were noted with apparent approval in the March 2013 edition of *High Net Worth*, 'a unique monthly publication that provides a digest of data and insights for professionals who market and sell to the wealthy' (<https://www.ledburyresearch.com>). This cited evidence, albeit unsourced, showing that prime London homes were worth more than all dwellings in Wales, Scotland and Northern Ireland, with the increase alone since 2007 worth more than all of the dwellings in the northeast of England:

Houses in London's 10 most expensive boroughs are now worth £552bn – as much as the entire property markets of Wales, Scotland and Northern Ireland combined. Since 2007, house prices in these boroughs have risen 15%, underpinned by demand from overseas buyers. The increase alone, worth £5140bn, is a sum larger than the value of all residential property in the north-east of England. The central boroughs of

² Unpublished at time of writing, material made available to the author by Hometrack and cited here with the approval of Mr R O'Donnell of Hometrack.

Westminster and Kensington & Chelsea are both worth more than £90bn, an increase of close to 50% on 2007, giving them a combined housing wealth greater than Wales (Ledbury Research, 2013: 7)

6. Conclusions

There has been strong growth in the number and wealth of the global super-rich during the last 20 years. They have become more diverse, with rapid growth in numbers and wealth in post-communist Russia and China and with strong growth in other countries outside of Europe and North America. The super-rich have emerged largely unscathed from the GFC and captured much of the net economic growth of the last 10 years.

Housing is a key element in their investment and consumption strategies and their purchase of trophy homes is often linked to their desire to access particular locations, especially in key global cities but also within countries where residential bases offer a range of advantages. They are highly mobile and own many homes in various countries, both as assets to be used as part of overall investment strategies and as bases for business and leisure visits.

Their residential property purchases are having profound impacts on demand for and prices of prime residential real estate in global cities and leisure regions. There is strong evidence to support the hypothesis that this has been a particularly significant driver of continuing growth of prime real estate prices in London, even during a period when house values have been static or falling across most of the UK and even across parts of London. Thus parts of the city's housing market have become de-coupled from developments elsewhere in UK housing.

It is concluded that that these developments are not merely cyclical, rather they mark a new phase in the nature and development of trans-national real estate markets and the changing role of prime residential property in London, New York and other key safe haven locations.

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25 years of National Housing Bank

↳ By R.V. Verma

The housing finance system in India has grown over the last quarter century from a very nascent stage to its present form. It comprises a large number of institutions who are offering multiple product options in a robust consumer-led vibrant market. The housing finance system today is fully integrated with the broader financial market in the country.

Set up by an Act of Parliament, and functional since 1988, National Housing Bank [NHB] has the charter to shape and grow the housing finance market in India. The Bank is a multi-functional Development Finance Institution [DFI] and performs a range of activities including financing, regulation and supervision, and promotional. As a wholesale funding institution, NHB supports a number of retail lending institutions in the home loan market, improving access to mortgage credit for people in all segments of the population. With its oversight function, the Bank implements policies that enhance confidence of all stakeholders, resulting in expansion and stability in the housing finance market.

In its journey of 25 years, the Bank has brought considerable depth and maturity to the mortgage market in India. Responsive regulation, financial support in the form of equity participation and long term loans, capacity building support and its advocacy role in the policy space are some of the important aspects of NHB's contribution to the sector's growth. This has transformed the Indian market into a sound and sustainable system, serving all segments of the population. The Bank's policies and programmes have led to a healthy integration of mortgage market with broader financial sector and the capital market.

As a matter of conscious policy, the Bank has judiciously combined its various roles viz. financing, regulation and promotion, for optimum impact on the sector, resulting in an

expanded mortgage market, capable of serving diverse population segments in the country. The Bank's programmes of financial assistance have focused on inclusive and sustainable growth, largely through a market-based approach. The Bank's initiatives and policies have allowed increasingly greater space to the market to operate efficiently in a well regulated competitive environment, in the best interest of the consumers in all income segments.

Against the backdrop of huge housing shortage among lower income segments, NHB has adopted a multi-pronged approach in tackling this problem. These include institution-building initiatives and measures for creating conducive environment for innovative practices in supporting the market to serve the low and moderate income segments. NHB extends concessional loan assistance to mortgage lenders to improve home ownership among low and moderate income households. Some recent initiatives include institutional measures for risk mitigation through mortgage credit guarantee institutions and funds, which improve affordability for the borrowers and encourage and incentivise the lenders to serve these important market segments. Advocacy and coordination roles are a critical function of the Bank.

The initiatives and measures of NHB have resulted in rapid and sustained growth in the mortgage industry. Regulations have brought about stability, financing has provided support to retail lenders for better growth and viability, capacity building has improved skill-sets in the industry, enhancing the confidence of the lender community, and the overall market sentiments. There is improved flow of credit to underserved segments, bringing about positive change in their quality of life. NHB's policies and its business model encourage market-based solutions for affordable housing. Improving sus-

tainability and viability of the housing finance system is the core aspect of NHB's developmental Charter. Promoting inclusive housing as a vehicle for financial inclusion is central to NHB's programmes. To optimize reach, NHB uses the vast infrastructure of the financial system, that include commercial banks, rural banks, housing finance institutions, microfinance institutions and public housing agencies. The Bank thus ensures depth and reach through a large set of intermediary institutions.

In accordance with its Charter, NHB operates on business principles with due regard to the public interest. Consistent with its charter, the Bank combines principles of market orientation with social objectives in its policies and business model. NHB's Schemes are focused on the disadvantaged and the unserved population, including people in the informal sector. Developing an all-round ecosystem for environment-friendly and energy-efficient residential settlements is an important consideration in the Bank's policies and programmes. Besides core housing, NHB is also supporting a number of water and sanitation programmes on stand-alone basis for cleaner, habitable settlements. Towards social objectives, the Bank's programmes include incremental housing, additions and up-grading to existing housing units, provision of basic amenities and infrastructure that add to overall quality of life and surrounding environment.

The NHB Act envisions an overarching role for NHB as an apex institution that can catalyse financing and bring about improvements in governance standards through its oversight function. To serve its mandate effectively, NHB works closely with the policymakers at central, state and local levels as well as regulators and the financing community along the entire value chain. NHB's close association with the Union and state governments in formulation of their

policies and programmes offers opportunities for advocacy and a coordination role in dissemination of best practices, consistent with larger social values and responsibilities.

Inclusive housing is an important agenda for NHB involving, *inter alia*, the creation of a complete ecosystem, on the demand as well as supply side, with the larger objective to boost home ownership among target segments. An inclusive housing “approach” brings marginalized and neglected segments of the society to social mainstream by empowering them through home ownership. A home provides them with social recognition, financial strength and self esteem, all of which go a long way in improving overall quality of life. All of this reinforces social values and the humanitarian cause at individual and community level, contributing to nation-building.

The inclusive approach of NHB seeks to address the needs of a diverse market across a wide geographic and income segments. The Bank is operating a number of products and schemes across all these market segments. Internal cross-subsidization and differential pricing have helped in reaching out to a vast segment of the population. As a developmental institution, the inclusive business model is based on high-volume-low-margin approach. This has helped NHB improve access to the market for a large segment of the unserved and underserved population. The policy of the Bank has improved inclusion through affordability and adequate availability of credit at the sectoral level. In pursuit of the social objective of inclusive housing, NHB’s business reflects a multi-pronged and multi-product approach for different market segments in urban and rural areas. At the apex level in the hierarchy of institutions, the Bank is able to respond quickly to the emerging market changes and sectoral dynamics with a view to optimizing its contribution to the sector through a responsive and sustainable business model.

Working through the years through its policy and advocacy roles, the NHB has brought into focus, the issue of formal housing credit for lower income segments. The complexities of the housing market and the growing informal segment notwithstanding, the various Schemes and programmes of the Bank have brought about gradual but definitive change in the way retail lending institutions perceive these markets. It has encouraged institutions to look closely at their operating models so that they can successfully tap the potential of this market segment. There is a huge resonating effect in terms of

improved participation by market intermediaries. Recognition of the lower and moderate income segments as a viable and bankable potential market for the lenders and the realization among people themselves of the long term benefits of economic empowerment through housing have together fuelled the aspiration of the people. For a vast segment of the population, a “house” as a permanent asset and substantive collateral adds to their quality of life. This is a game changing reality which is the result of a series of groundbreaking initiatives of the NHB through the years, in close partnership with the other stakeholders and the industry practitioners.

A key challenge in integrating informal and formal markets is the lack of awareness and capacity among lending institutions to serve borrowers in the informal market. Continued efforts in this field by all the stakeholders have resulted in better integration of the informal sector with the formal financial market which has improved the credit availability and home-ownership for these people. Although scaling-up is a challenge at this stage, it offers enormous opportunities to the primary lending institutions once they have their business models in place.

Some other key aspects of a growing and vibrant market in India are consumer orientation through measures to promote transparency, information availability and fair practices across the industry. NHB’s role in all these areas are challenging as the market is rapidly evolving. NHB’s policies have resulted in proliferation of specialized housing finance institutions which are now number fifty-six, operating in a fiercely competitive environment, alongside the banks. A judicious mix of NHB’s promotional, financing and supervisory (oversight) functions has proved to be a unique model responsible for sustained expansion of the mortgage industry together with stability and diversity, coupled with growing and strong fundamentals.

While expanding the overall housing market is vital, it is as important to accord due attention to energy conservation and energy efficiency. In line with India’s position as a responsible member of the international community, the Government of India has been implementing a number of policies and programmes to boost energy efficiency in the residential sector. Partnering in this Initiative with the Government of India and its global counterparts (KfW of Germany), NHB is implementing home financing programmes designed to ensure optimum results with significant impact on environment protection and

energy conservation. NHB is working to promote energy efficiency in the residential sector. NHB’s initiatives in this niche market segment have demonstrated the potential for addressing these issues through financial sector intervention.

NHB recognizes the importance of promoting micro-mortgages in the country. Through a variety of risk mitigation measures and financial support, NHB has catalyzed development of the micro-mortgage market, as many successful regional players have now emerged, paving the way for improved home ownership among people with modest means, right across the country. Development of new financial products and delivery mechanism, standardization and dissemination of operational processes for extending and servicing small mortgages have brought about a paradigm change in the industry’s outlook towards these segments. The business model is replicable in both domestic and international markets. Among other features, it includes strengthening the capacity of MFIs and other lenders to finance and support the housing needs of people in slums and the informal sector. The challenges involved in identification and aggregation of such demand, risk assessment and borrowers-qualification standards, loan servicing capabilities, etc are well recognised and NHB, in partnership with IFC (member of the World Bank Group) and the World Bank is exploring ways to overcome these challenges. These initiatives and products have led to a closer integration between the formal and informal sectors through financial intervention. The potential business opportunity also brings with it a sense of social responsibility, together comprising a virtuous cycle, which can be self-perpetuating. NHB’s journey in promoting socially relevant and market oriented lending programmes through an inclusive approach, has been possible through collaboration with various other stakeholders and domain knowledge partners, in the domestic and the global space.

The integrated approach of bringing together the various elements of the housing finance ecosystem, has, to a large extent started yielding fruit, since the low income housing finance market is set to expand and become self-propelling as the number of players looking at this market space is rapidly increasing. There has been valuable learning from a number of pilots conceived and supported by NHB, resulting in a steady improvement in the low income segments’ access to affordable housing, and with all of these developments promising to usher in a better tomorrow.

Latest ideas on the structural reform of the banking market and its effect on housing finance

↳ By Christian Koenig

1. Introduction

The current financial crisis led to a huge world-wide effort to regulate the banking sector and to stabilize the risks for the real economy in each country. Within the US the Dodd-Frank Act has been one of the earliest interventions in this area, but the European Union is also very active in this field as well as many European States.

This article offers an overview of the different measures established or currently under discussion. In addition to legislative measures in the area of consumer protection, especially for mortgage credit,¹ governments came to the conclusion that certain reforms concerning the banking structure seemed necessary. Nowadays law makers compare legislative efforts in other jurisdictions and sometimes copy and paste, or take the opportunity to shape their own financial legislation in a way that puts pressure on other states to copy it. This is especially the case in Europe, where national governments sometimes try to be faster than others in order to establish a common trend and limit the discretion of the European Union to develop common rules for Europe. The G20 agreements and recommendation also put common pressure on regulators and national parliaments to draft rules in order to solve common identified problems. But law makers across the Atlantic also tend to observe US legislation.

2. The US Dodd-Frank Act

2.1 Parallels with European legislation?

The Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law on 21 July 2010. With a total of 1601 sections, this mammoth statute, which comprises numerous individual laws, was named after Senator Christopher Dodd, the then Chair of the Senate Committee on Banking, Housing, and Urban Affairs, and Barney Frank, the then Chair of the House of Representatives' Committee on Financial Services. This federal law is intended to be the US federal legislators' response to the subprime mortgage and financial sector crisis in the United States. The Act changes the existing regulatory structure, creating a host of new agencies at federal level and increasing the oversight of individual companies and financial institutions regarded as contributing to systemic risk. It tightens the regulations relating to credit rating agencies, equity, and deposit insurance, introduces restrictions on mergers and acquisitions by deposit-taking institutions, establishes standards for mortgage lending, deals with financial remuneration of heads of institutions, and regulates hedge funds and the minerals trade. It also includes extra-territorial provisions aimed at combating corruption. In total, the Act contains more than 400 statutory authorizations for subordinate federal authorities to develop regulations and standards.

2.2 Changes to the regulatory system

The core element of the Act is its focus on institutions regarded as creating systemic risk. It therefore establishes the Financial Stability Oversight Council which, like the European Systemic Risk Board², is composed of representatives of various regulatory authorities and undertakes comprehensive monitoring in order to identify and avert risks to the United States' financial stability at an early stage.³

Among other things, it may determine that non-bank financial companies⁴ could pose a systemic risk to the financial stability of the United States and should therefore be supervised by the Federal Reserve⁵. The Council is also charged with coordinating regulatory measures, identifying any gaps in regulation, and making recommendations on legislation to Congress. Dodd-Frank also establishes, for the first time, an agency responsible for the financial regulation of insurance companies at the federal level, namely the Federal Insurance Office⁶. Previously, insurance – with very few exceptions⁷ – was regulated by the individual US states. Insurance is dealt with in Title V of the Dodd-Frank Act, which contains various provisions for the regulation of non-admitted insurance and reinsurance⁸. The Federal Insurance Office is authorized to monitor all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute

¹ See Housing Finance International, III/2012 Housing Finance International, p. 23, "European Union opts to regulate mortgage credit"

² Art. 1 ff. of Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board

³ See also Heppel, Tielmann WM 2011, p. 1883 ff.

⁴ Section 113 Dodd-Frank

⁵ Section 114 Dodd-Frank

⁶ Section 502 Dodd-Frank

⁷ Such as the Terrorism Risk Insurance Act of 26 November 2002 and the Liability Risk Retention Act of 1986

⁸ Non-admitted insurance

to a systemic crisis in the insurance industry or the financial system of the United States. It also has a policy mandate to monitor the extent to which traditionally underserved communities and consumers have access to affordable insurance products. The Office of Thrift Supervision, previously responsible for the supervision of mortgage banks, savings banks, and savings and loans associations, was abolished as of October 2011⁹ and its functions were transferred to the Comptroller of the Currency. The Comptroller of the Currency regulates and supervises all national banks and federal savings associations. As before, the Federal Deposit Insurance Corporation is the primary federal regulator of banks that are chartered by the states. For the purpose of monitoring the derivatives market, the Act establishes the Commodity Futures Trading Commission¹⁰ alongside the existing overseer and regulator of the US securities markets, the Securities and Exchange Commission. Under Title VII, the provisions of the Wall Street Transparency and Accountability Act (Section 711 ff.) regulate over-the-counter [OTC] swaps and the derivatives market. Under the new rules for which this Title makes provision, all swaps must be cleared by a clearing house. Capital and margin requirements are introduced for market participants, along with conduct-of-business rules and transparency requirements.

It also establishes an Office of Credit Ratings as a separate unit within the Securities and Exchange Commission, with responsibility for supervising credit rating agencies. The Securities Exchange Act is amended accordingly¹¹. Alongside the existing supervisory authorities, monitoring consumer protection in the financial services industry will be carried out by a new federal agency, the Bureau of Consumer Financial Protection¹². An Office of Financial Research¹³ is established within the Department of the Treasury to support the Bureau's work.

2.3 Deposit insurance

The Dodd-Frank Act also amends the US's existing regulations on deposit insurance¹⁴. The Act permanently raised the maximum deposit insurance from USD100,000 to USD 250,000, with this increase extended retrospectively to 1 January 2008¹⁵. The provision making the law retrospective, introduced at the request of the mediation committee in Congress, means that the USD 250,000 deposit insurance amount covers otherwise inadequately protected depositors in institutions such as IndyMac Bank¹⁶ which failed on 11 July 2008.

Furthermore, Dodd-Frank requires that the DIF reserve ratio reach 1.35%¹⁷ within 10 years, i.e. by 30 September 2020. Previously, the DIF reserve ratio was 1.15% of estimated insured deposits. Dodd-Frank requires the Federal Deposit Insurance Corporation [FDIC] to offset the effect of increasing the reserve ratio from 1.15% to 1.35% on institutions with total consolidated assets of less than USD10 billion¹⁸. The background to this amendment was Congress' desire to see a greater burden imposed on larger banks.

2.4 Securities

Under the headline Investor Protections and Improvements to the Regulation of Securities, the Act introduces a number of reforms relating to the refinancing of mortgage credit through securitization¹⁹. Firstly, the Securities and Exchange Commission is tasked with various functions relating to the regulation and oversight of brokers, dealers and investment advisers²⁰. Secondly, the Commission is mandated to establish an Investor Protection Fund financed by monetary penalties, which is intended to pay awards to whistleblowers²¹. The Act also contains further very detailed provisions governing the amount payable, circumstances under which an award to a whistleblower will

be denied, and measures to protect the identity of a whistleblower. The Act also provides for the appointment of an Ombudsman to act as a liaison in resolving problems between the Commission and investors²². Tellingly, in the Act, legislators grant a mandate for the preparation of numerous studies²³ of potential measures which are intended, in principle, to increase investor protection, but introduce few practical measures for this purpose. The most significant change in the provisions regulating mortgage-backed securities [MBS] is the requirement, mentioned above, for the issuer to retain not less than 5% of the credit risk for any asset that is not a qualified residential mortgage²⁴. Further provisions relate to disclosure and information, requiring each issuer of an asset-backed security to disclose, for each tranche or class of security, information regarding the assets backing that security.

Unlike the European Parliament rapporteur's proposed amendments to Article 18 h), i) and j) of the Commission's proposal for a Directive on credit agreements relating to residential property, the Dodd-Frank Act does not envisage the establishment of a register to record financial instruments collateralized against credit agreements relating to residential immovable property.

2.5 Credit rating agencies

As one of the lessons learned from the financial market crisis, the Dodd-Frank Act radically amends the provisions of the Securities Exchange Act relating to credit rating agencies. It provides for the establishment of a supervisory body, the Office of Credit Ratings, within the Securities and Exchange Commission²⁵. The Office's task is to protect the users of credit ratings, to conduct reviews to determine whether the rating organizations are adhering to policies and procedures, to review and publish annual reports, and issue, suspend or permanently revoke the credit rating agencies' registration²⁶. In their annual

⁹ Sections 311 – 313 Dodd-Frank

¹⁰ Section 712 Dodd-Frank

¹¹ Section 932 Dodd-Frank

¹² Section 1001 ff. Dodd-Frank

¹³ Section 151 Dodd-Frank

¹⁴ Federal Deposit Insurance Act of 1950

¹⁵ Section 335 Dodd-Frank

¹⁶ See Federal Deposit Insurance Corporation: Failed Bank Information for IndyMac Bank, F.S.B., and IndyMac Federal Bank, F.S.B., Pasadena, CA: <http://www.fdic.gov/bank/individual/failed/IndyMac.html>

¹⁷ Section 334 a) Dodd-Frank

¹⁸ Section 334 e) Dodd-Frank

¹⁹ Section 911 ff. Dodd-Frank

²⁰ Section 911 Dodd-Frank

²¹ Section 922 Dodd-Frank

²² Section 919 D Dodd-Frank

²³ Section 917 – 919 C Study regarding financial literacy among investors, Study regarding mutual fund advertising, Clarification of Commission authority to require investor disclosures before purchase of investment products and services, Study on conflicts of interest, Study on improved investor access to information on investment advisers and broker-dealers, Study on financial planners and the use of financial designations.

²⁴ Section 941 Dodd-Frank

²⁵ Section 932 Dodd-Frank

²⁶ Section 932 Dodd-Frank

reports, the credit rating agencies must disclose their procedures and methodologies, the main assumptions and principles used, the potential limitations of the credit ratings, and information on the reliability, accuracy, and quality of the data relied on²⁷. These agencies' previously privileged status under the Securities Exchange Act is now revoked, with new liability exposure imposed on these agencies for false or misleading statements. Furthermore, the regulator is required to issue rules on qualification standards for credit rating analysts²⁸, and to ensure that credit rating agencies apply ratings in a consistent manner²⁹. Whereas the European regulations on credit rating agencies³⁰ contain provisions concerning the independence and effective supervision of these agencies and the avoidance of conflicts of interest, and the Commission's recent proposal for a Regulation calls in particular for mandatory rotation of CRAs, the Dodd-Frank Act contains no analogous provisions.

2.6 Volcker Rules

Another very important part of the Dodd-Frank Act is the implementation of the so called Volcker Rule³¹ in a specific section³². This rule prohibits banks from proprietary trading and restricts investment in hedge funds and private equity by commercial banks and their affiliates. The US Congress did exclude certain permitted activities of credit institutions, their affiliates, and non-bank institutions which are identified as systemically important, such as market making, hedging, securitization, and risk management. The Volcker Rule also proposes a limit to the ownership in hedge funds and private equity funds at three percent for credit institutions.

In Europe the former Glass Steagall Act³³ is often taken as the historic example for these limits

on proprietary trading. The Banking Act of 1933 (Glass-Steagall Act) contained provisions that prohibited commercial banks from underwriting, promoting, or selling securities directly or through an affiliated brokerage firm.

With this prohibition it created a separation of the banking system and created so called Chinese walls between commercial banking and investment banking. But during subsequent years this separation of banking business activity was gradually weakened and was finally brought to an end by the Financial Services Modernization Act of 1999³⁴, which repealed the last remaining restrictions imposed by the Glass-Steagall Act. The implementation of the Volcker rule in the Dodd-Frank Act is now reversing previous development slightly by re-erecting portions of Glass-Steagall's Chinese wall.

3. European initiatives

3.1 New banking supervisory structure within the EU

Already in February 2009 the European Commission asked Mr. De-Larosière³⁵ and several other experts to draft ideas concerning the reform of the European financial regulatory system. Among other provisions the report proposed a new European framework for safeguarding financial stability, in the sense that macro-prudential supervision should be undertaken by a new European Systemic Risk Council [ESRC].

After this recommendation the new committee was established under the European Central Bank [ECB]³⁶ and is now chaired by the President of the ECB. This Committee gathers information on all macro-prudential risks in the EU.

For micro-prudential supervision this report proposed a new European System of Financial Supervision [ESFS]. The so called Level 3 Committees [CEBS, CEIOPS, CESR] have been transformed into three new European authorities: the European Banking Authority³⁷, the European Securities Authority³⁸ and the European Insurance Authority³⁹. The EU invested these authorities with substantial supervisory competence in their respective fields. They can adopt binding supervisory standards, binding technical decisions applicable to individual institutions, they oversee and coordinate the so-called colleagues of national supervisors, and they have the right to license and supervise specific EU wide institutions and have other competences.

This system of new supervisory structures for all EU Member States did not stay unchanged for long. In the light of the banking crisis in some EU Member States, there was a political wish to support some crisis-stricken Banks with money from the European Stability Mechanism [ESM] which has been established as a permanent crisis resolution mechanism for the countries of the euro area. The political compromise was that if the banks could be capitalized directly by the ESM, then there also should be real supervisory control by a European institution. Due to strong resistance, especially from the British government, the European Council refrained from implementing the original idea to authorize the European Banking Authority in relation to new competences, but decided that the European Central Bank (which was until now only the Central Bank of the Euro-Zone, but not a supervisory institution), would supervise all banks in the Euro-Zone⁴⁰. In the following debates at the European Parliament and the Council, the EU institutions opted for a compromise in that only banks which are of significant relevance

²⁷ Section 932 Dodd-Frank, with amendments to Section 15 E of the Securities Exchange Act

²⁸ Section 936 Dodd-Frank

²⁹ Section 938 Dodd-Frank

³⁰ Regulation (EC) No 1060/2009 of 16 September 2009 on credit rating agencies; Proposal for a Regulation amending Regulation (EC) No 1060/2009 on credit rating agencies, 15 November 2011 (COM 011/0361 (COD))

³¹ Paul Volcker, former Chairman United States Federal Reserve

³² Section 619 of the Dodd-Frank

³³ US Banking Act from 1933

³⁴ Gramm-Leach-Bliley Act from 1999

³⁵ Jacques Martin Henri Marie de Larosière de Champfeu has been Director of the International Monetary Funds and President of the Banque de France (1987-93) as well as President of the European Bank for Reconstruction and Development

³⁶ Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24/11/2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board and Council Regulation (EU) No 1096/2010 of 17/11/2010 conferring specific tasks upon the European Central Bank concerning the functioning of the European Systemic Risk Board

³⁷ Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending

³⁸ Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC

³⁹ Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Insurance and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC

⁴⁰ Proposal for a Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions from 12.9.2012 COM(2012) 511 final 012/0242 (CNS)

would be transferred to the supervision of the ECB. Only banks with an overall balance sheet volume of 30 billion Euro and banks which are active in several participating Members States are significant in that sense. There are also other criteria for determining which credit institutions are to be supervised by the ECB in the future. These rules will apply one year after the regulation comes into force which has not yet happened. Now the ECB will have to establish a separate entity in order to deal with these new supervisory tasks. The European Banking Supervisor in London will now focus more on developing regulatory standards, whose implementation will then be supervised by the ECB but only for the so called significant institutions. All other institutions will still be supervised by national supervisors. This will make banking business much more complicated than before.

3.2 Implementation of separation of banking business in Europe

Apart from these substantial reforms to the new supervisory structure in Europe, the European lawmakers are also regulating (under the concept of a "Banking Union") the reform of the deposit guarantee systems in Europe and the so called crisis management⁴¹ for credit institutions. They will require a concrete plan for drafting recovery and resolution plans as well as creating national resolution authorities and funds. Later on they will create a European wide resolution authority, possibly with its own funds and with contribution obligations imposed on all credit institutions in Europe. But a parallel discussion took place at the European level on the mandatory separation of own trading activities similar to the debate of the Volcker Rule in the US.

3.3 Liikanen-report on the reform of the EU-Banking sector

Erkki Liikanen⁴², was appointed in February 2012 by the European Commissioner for the Internal Market to elaborate, together with other experts, in addition to ongoing regulatory reforms, which structural reforms of EU banks would strengthen financial stability and improve efficiency and consumer protection. This expert group has been working behind closed doors, they assessed

the benefits and disadvantages of the Volcker Rule⁴³ in the US, the ring fencing proposal of the British Vickers Commission⁴⁴ and other possible options like the separation of banking business as in the Glass-Steagall Act, or higher capital requirements as in Switzerland. Finally the report was published on 2 October 2012 and the European Commission is now considering implementing their ideas.

The proposals of the Liikanen-group can be summarized in five topics:

3.2.1 Separation of proprietary trading

As in the Volcker-Rule in the US, the European expert group strongly supports the separation of relevant proprietary trading and other significant trading activities. These activities should in the future be undertaken by a separate legal entity if the activities to be separated amount to a significant share of a bank's business. According to the expert group this would ensure that trading activities beyond the threshold are carried out on a stand-alone basis and separate from the deposit taking bank. The more risky trading activity should according to their report not directly be supported by the deposits of their customers. However, they argued that the long-standing universal banking model in Europe would remain untouched, since the separate activities would be carried out within the same banking group.

According to the opinion of the expert group only a significant proportion of proprietary trading should be separated. This would be defined as 15 %-25 % of the total balance sheet, or if it would amount to at least a value of 100 billion Euros. According to a footnote in this report this obligation will apply to all kinds of banks, from a cooperative to a public ownership structure or a public limited company.

The reason for this specific proposal concerning the separation of proprietary trading from other banking business, is that the expert group's report comes to the conclusion that the past financial crisis did not prove that a particular business model was inherently good or bad. According to the report excessive risks in pro-

proprietary trading and highly complex products or real estate financing plus reliance on short-term savings deposits caused the crisis. As a further cause of the banking crisis, the expert group identified the strong interconnectedness of the financial institutions. As a conclusion, the experts did not follow the approach of the Volcker rule in the US to ban proprietary trading, but they suggested that risky business activity be transferred to a legally distinct entity, if that activity amounts to a significant proportion of the activity of the relevant institution.

Proprietary trading is defined by the expert group as the granting of loans, borrowings or the granting of unsecured credit liabilities to hedge funds, SIVs or other units of a comparable nature. Also, private equity investment business should be transferred to this newly established unit. The expert group also suggests that European law should provide for appropriate transition periods and set out the details for the separation of proprietary trading.

3.2.2 Common rules for the recovery and resolution for credit institutions in the EU

The expert group also suggests that it is absolutely necessary to have harmonized European rules for the recovery and resolution of credit institutions. In this context, the Group of Experts welcomes the proposal on crisis management by the European Commission.

The Expert Group proposes that the national resolution authority should have broad powers with respect to the depreciation and impairments or loss of assets which are necessary to rehabilitate the bank and maintain its key functions.

3.2.3 Bail-in tools

In the context of resolution tools the experts also urge the importance of the proposed bail-in instruments within the so called Crisis Management Directive. The European Commission has proposed that every credit institution should issue bail-in instruments. In the event of a crisis, the resolution authority could then propose a hair-cut on these claims and help the institution to continue its core business. The expert group argues

⁴¹ Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010 COM(2012) 280/3

⁴² Finnish social democratic politician, former EU Commissioner and currently the Governor of the Bank of Finland

⁴³ Section 619 of the Dodd-Frank

⁴⁴ The Independent Commission on Banking: The Vickers Report http://www.hm-treasury.gov.uk/fin_stability_reform_icb.htm

that such bail-in instruments will increase the ability of the bank to absorb losses. In this context it would be important to ensure that appropriate claims of unsecured creditors are easier to write off or can be optionally transferred into shares of the institution. Because of the risk of interconnectedness of the institutions within the financial market, bail-in requirements should not be held by the banking sector. Moreover, the experts suggest that bail-in requirements should also be offered as part of the remuneration system of management to indirectly discipline the management and their decisions.

3.2.4 Strengthen own capital requirements

The expert group also calls for more robust capital requirements beyond the standards of Basel III / CRD. The European Commission is asked in the context of the reform of the Basel Committee's considerations to reform the trading book to consider whether these reforms in relation to the credit risk of European banks are sufficient. Furthermore the expert group supports the recommendation of the FSB [Financial Stability Board] concerning future maximum loan to value [LTV] and loan to income [LTI] limits but they do not provide specific limits.

3.2.5 Governance

The experts also suggest strengthening and adapting the rules concerning the governance of credit institutions. In this context, the expert group proposes to strengthen risk management, create rules on remuneration for management and staff and provide improved risk disclosure and sanctions for the supervisor.

As part of the required risk management, the experts suggest additional rules to implement CRD III and VI in the Member States. In relation to the remuneration rules in the CRD III and VI Directive they suggest that in future 50% of the variable remuneration of directors should be issued in the shares of the relevant institution and that a significant proportion of variable remuneration should comprise bail-in instruments in order to offer an incentive to enforce good corporate governance. Where appropriate, they also propose a limit for variable remunera-

tion when compared to the fixed salaries of the management of the bank. Bonuses should not be higher than the dividend that is paid.

The European Commission announced after the publication of this report that it will consider how to implement these ideas into European law. Currently the European Commission is consulting on this issue in terms of regulating the too-big-to-fail issue and the separation of proprietary trading for systemically important banks in the EU⁴⁵.

In the area of separating proprietary trading activity several EU countries have proposed legislation within the last months or are at least consulting on the issue.

4. New rules for the reform of banking structures in Germany

In 2011 the German Parliament agreed on a new law regulating⁴⁶ the recovery and resolution of credit institutions, creating special insolvency rules for credit institutions. But these new resolution rules are only applicable to systemically important banks. In addition, Germany has created a resolution fund, which will also financially support systemic relevant credit institutions for Germany, but every credit institution will have to pay contributions to this fund.⁴⁷

On 15 January 2013 the German Government proposed a new law in order to allow concrete resolution and recovery planning and the mandatory separation of proprietary trading.⁴⁸

The FSB standards from October 2011 concerning the Key Attributes of Effective Resolution Regimes for Financial Institutions⁴⁹ and the commitment of the G20 Heads of States to develop standards for the recovery and resolution for systemically important banks were the key driver for the German government to propose these legal changes. In addition, Germany wanted to establish explicit rules for the creation of recovery and resolution plans which will be mandatory according to the proposed Directive of the European Commission.

The most significant deviation from the European Commission's proposal is that the German law provides for the creation of recovery and resolution plans only for systemically important global and national banking institutions and financial groups. The directive of the European Commission makes no differentiation in this respect.

Basically, the law can be divided into two chapters. First, all systemically important banks and financial groups will have a duty to create recovery plans in preparation for coping with a potential crisis. Credit institutions will have to develop scenario-based policy options for the management which can be used in situations of financial stress in order to ensure the viability of the bank. The Act also provides that a new future unit should be established within the German Financial Services Supervisor [BaFin] which will be responsible for the development of resolution plans.

The second part of this Act deals with the separation of proprietary trading in the sense that credit institutions are prohibited from engaging in loan and guarantee transactions with hedge funds, if the credit institution or financial holding group has reached total assets of 90 billion euros at the closing dates for the last three financial years and the share of proprietary trading exceeds 20% of their total assets. In addition, these transactions need to be conducted by a separate legal entity if the proprietary trading exceeds the volume of 100 billion. According to unofficial statements of the German Ministry of Finance probably only the eight biggest German banks will be targeted with these new rules. Despite concerns in the Parliament, Germany introduced separation of banking business only to a few universal banks.

5. Banking reform in Great Britain

Several months after the publication of the Vickers⁵⁰ report⁵¹, which claimed, in essence, that credit institutions should hold more of their own equity than prescribed in Basel III and introduced the idea of ring fencing of retail

⁴⁵ Consultation of the European Commission from 16.05.2013 on the reform of the structure of the EU banking sector

⁴⁶ Gesetz zur Reorganisation von Kreditinstituten (Kreditinstitute-Reorganisationsgesetz -KredReorgG) in force since 1.1.2011

⁴⁷ <http://www.fmsa.de/en/>

⁴⁸ Entwurf eines Gesetzes zur Abschirmung von Risiken und zur Planung der Sanierung und Abwicklung von Kreditinstituten und Finanzgruppen

⁴⁹ http://www.financialstabilityboard.org/publications/r_1111104cc.pdf

⁵⁰ Sir John Vickers was Chief Economist at the Bank of England and a member of the Monetary Policy Committee he also served as Director General/Chairman of the Office of Fair Trading

⁵¹ The Independent Commission on Banking: The Vickers Report

banks activity, the UK Treasury published in June 2012 a White Paper⁵² with certain proposals for the reform of the British banking market. Subsequently, a corresponding Bill was presented to Parliament in October 2012.⁵³

This bill tries to implement most of the ideas of the Vickers Report into British law. Basically, the measures to reform the UK banking market can be divided into three aspects,

- Vital banking functions should be protected by the so-called "ring-fencing" of risks from the capital and financial markets,
- Secured deposits from customers rank ahead of other creditors in the case of a critical situation of the credit institution,
- The UK regulator can impose additional measures on banks in order to allow an easier absorption of losses.

In addition to these measures, the Government proposed that some banks should hold 3% more equity than agreed in the implementation of Basel III compromises at EU level.

Also with regard to the loss absorbing capacity, the British Government referred to the compromise on the implementation of Basel III at the EU level and argued that Member States have discretion to implement this within the framework of the so called second pillar which would also allow for implementing the proposal of the Liikanen-group concerning the "bail-in" instruments.

According to the proposed law, credit institutions in general have to surround the so-called vital banking functions with a protective wall. The scope of these measures is further clarified, so that the basic activities of credit institutions, namely the collection of deposits from depositors and small and medium enterprises should be protected. Accordingly, all deposit-taking institutions should be protected from risky businesses. HM Treasury will be authorized to prohibit certain investment transactions, if the collection of deposits is not the main activity of the institution.

The classic deposit taking institution will be prohibited from conducting investment business through proprietary trading. Thus Great Britain is copying the U.S. Volcker Rule. However, the Treasury in this regard will also be empowered

to determine exceptions when under certain special circumstances proprietary trading by a bank can be permitted. The Treasury may allow a deposit-taking institution to undertake proprietary trading activities if these activities are judged to be not capable of causing significant damage to the provision of vital banking services in the United Kingdom. The Treasury can also allow smaller deposit taking institutions with deposits of up to 25 million pounds to continue their proprietary trading activities.

In addition, the Bill provides that the ring fenced deposit-taking institution has to ensure that if it is part of a financial group then it can still act independently from the rest of the group. This requirement, which will be monitored by the supervisor soon, is summarized in the Bill to the effect that the deposit-taking institution has to be legally, economically and operationally independent and must be managed by an independent board. Further details in this regard will be defined by the supervisory authority.

With this new British approach of "ring fencing" the British Government decided against a general separation of banking business but opted for a prohibition for larger deposit taking banks from engaging in proprietary trading business. If these institutions wish to continue to undertake proprietary trading, this activity must be split off and needs to be operated by an independent legal entity.

6. New rules for the reform of banking structures in France

The French government also proposed at the end of 2012 a comprehensive legislative proposal⁵⁴ for the re-regulation of the French financial markets, which had already implemented some of the recommendations the Liikanen expert group proposed a few months before.

Much as in the United Kingdom, in France the separation of proprietary trading at banks where it is a significant proportion of their activities will soon be required by law. In addition to the implementation of the currently debated proposal for an EU directive on recovery and resolution for credit institutions this new French law proposal will create a new authority for the resolution of credit institutions.

6.1 Prohibition of speculative business and proprietary trading activities

As suggested by the Liikanen group, the new Bill prohibits in the future any speculative proprietary trading activity in the investment sector by credit institutions. These activities will need to be transferred to a separate legal entity and will no longer be allowed to be operated by the bank on itself. Thus, the recommendations for the separation of significant proportions of proprietary trading by the Liikanen expert group will be implemented in France without any proposal by the European Commission on this issue yet.

The definition of "significant proportion" will be determined according to the law by decree of the Minister of Finance or the Supervisor.

In this context, it is also stipulated that banks should not hold shares in hedge funds in the future. Thus the French law takes over parts of the provisions of the Volcker Rule in the Dodd-Frank Act in the United States.

The definition of proprietary trading makes clear that certain proprietary trading activities will be still allowed in the future for credit institutions, such as market-making. The law also provides a corresponding list of permitted proprietary trading activities.⁵⁵

6.2 Transfer of new responsibilities to the supervisory authority

The recently created new financial market supervisory authority⁵⁶ will also take over the tasks of a resolution authority for the banking industry. This authority will be therefore renamed the "Financial Banking Supervision and Resolution Authority". The proposal for a Directive of the European Commission for the recovery and resolution of credit institutions and investment firms (crisis management) will provide that Member States have to set up or appoint a national authority with the task of winding up credit institutions. Under this new French law this authority is given the power to intervene in the markets and in certain finance activities and prohibit financial products or certain banking business practices if appropriate. All credit institutions will be required to develop

⁵² White Paper 'Banking reform: delivering stability and supporting a sustainable economy' from 14 June 2012

⁵³ Government proposal for a draft Financial Services (Banking Reform) Bill from 12 October 2012

⁵⁴ Projet de loi de séparation et de régulation des activités bancaires from the 19.12.2012

⁵⁵ Art. L321-1 Code monétaire et financier

⁵⁶ Autorité de contrôle et prudentiel

recovery plans.⁵⁷ The supervisory and resolution authority shall, as required by the Directive, design restructuring plans for individual institutions.⁵⁸ The authority will be also empowered to dismiss directors and appoint a temporary administrator.

The French supervisory authority may also transfer parts of the credit institutions to other entities or banks or pronounce a ban on settlement of liabilities. In the event of the failure of a financial institution, the Authority is authorized to distribute the losses to the shareholders/owners or creditors of the bank. The claims of depositors and government obligations will always have a prior-rank in this situation. However, French law does not provide for mandatory issuing of bail-in instruments.

6.3 Transfer of the deposit guarantee fund into a resolution fund

The previously existing French Deposit Guarantee Fund will be renamed the Deposit Insurance and Settlement Fund⁵⁹. This fund will in future not only guarantee deposits of depositors, but also

provide finance for resolution measures.

France has therefore taken the opportunity offered by the European Directive on crisis management to exploit the deposit insurance systems for financing the resolution of credit institutions as well. The contribution to this new fund will be regulated by Decrees of the French Ministry of Finance.

6.4 Creation of a new supervisory structure in order to detect and prevent systemic risk in the financial sector

France will create a new supervisory committee that is similar to the American,⁶⁰ European⁶¹ and German⁶² models, in order to detect and prevent systemic risk in the financial sector⁶³. The lawmaker will transfer considerable power to this new authority in the sense that it may require that the credit institutions increase their own capital in order to avoid systemic risk. In order to prevent speculative bubbles this new supervisor can impose restrictions on banks and lending standards.

7. Conclusion

All these reforms at national level or at the European Union level will challenge the future business activities of credit institutions in their relevant markets. The intention is to create a more stable environment and banking structure in order to prevent a further banking crisis. A common approach of all of these measures is that risky banking business is identified and in much legislation lawmakers tend to force bigger credit institutions to separate these risky activities in a separate legal entity. Governments and parliaments have agreed mostly on the fact that necessary banking business for consumers, such as collecting deposits, needs to be ring fenced and protected from riskier banking business. Separating general banking business has not been identified as an option. Specialized credit institutions, like the Building Societies in Ireland and Britain, or the Bausparkassen in Europe are already operating by law under the so called ring fenced approach in order to safeguard deposits and define their scope of business.

⁵⁷ Art. L612-8 Code monétaire et financier

⁵⁸ Art. L612-33-1 Code monétaire et financier

⁵⁹ Art. L312-4 ff Code monétaire et financier

⁶⁰ Art. 113 Dodd Frank

⁶¹ Europäischer Ausschuss der Systemrisiken nach der Verordnung EU Nr. 1096/2010 vom 17. November 2010 zur Betrauung der Europäischen Zentralbank mit besonderen Aufgaben bezüglich der Arbeitsweise des europäischen Ausschusses für Systemrisiken

⁶² Ausschuss für Finanzstabilität nach dem Finanzstabilitätsgesetz

⁶³ Conseil de stabilité financière

Does Australia's National Consumer Credit Protection Act limit practices that can lead to housing over-indebtedness?

↳ By Mary R. Tomlinson

1. Introduction

Much of the activity carried out in recent years in the financial marketplace has been primarily based on short term competition for growth or market share, rather than on long term sustainability. This included a substantial extension and leveraging of credit, particularly housing finance, which ended up being at the heart of the global financial crisis [GFC]. Australia's banks' often point to the fact that they did not adopt 'irresponsible' lending practices such as those pursued in the USA, and this is why they were able to emerge relatively unscathed from the crisis (ABA 2008; REIA 2010; Ellis 2012).

Alongside this position, however, are continuing warnings about the amount of housing debt held by Australian households (Keen 2009; North, 2009; Ramsay and Sim 2009; Berry *et al.* 2010; Fitch Ratings June 2011; Moody's 2011a). To demonstrate, the ratio of household debt to household disposable income has increased from less than 50% in 1990 to more than 150% in 2010, with much of it representing an increase in debt for housing (Yates 2012, p. 83 - 84).

In an earlier paper, Tomlinson and Burke (2012a) raised the concern that through their lending practices banks are able to mitigate their risk by passing much of it onto the borrower¹. This situation may act as an incentive for banks to

fiercely compete in the lending environment. Hence, the credit creation practices of lenders end up contributing to over-indebtedness and rising house prices (Keen 2009).

A survey carried out by the Financial Sector Union [FSU]² of 3,200 of its members found that there is constant pressure to meet sales-based remuneration targets and that 88% say a quarter of their take home pay is generated by sales of financial products (FSU 2011). Mortgage lending is counted toward lending targets both in terms of its volume and amount (Interview FSU).

A joint research project by Deakin University and the Consumer Action Law Centre also linked bank practices to rising personal debt (Harrison *et al.* 2012). Computer technology that analyses life-style stages and purchasing patterns is used to mine data which can be used to determine when customers will be more willing to take on additional debt, including encouraging borrowers to redraw additional funds, or to otherwise refinance or increase the amount of their housing loan.

This paper first briefly describes Australia's housing indebtedness. Secondly, in greater detail, it examines practices that have the potential to result in 'irresponsible' mortgage lending and therefore contribute to this over-indebtedness, by focusing on the:

- use by lenders of a Sales and Bonus culture which affects how financial sector employees engage with customers,
- use by lenders of technology to determine when consumers would be more willing to accept additional credit,
- benchmark lenders generally use to assess repayment capacity.

Third, the paper reflects on the new National Consumer Credit Protection Act, 2009 [the Act] (Australian Govt 2009), in particular, Section 3, which imposes a responsible lending obligation on lenders (both bank and non-bank³) and questions whether it will be of sufficient force to prevent such practices.

The paper draws on a range of sources, both government and non-government, that are concerned with the extension of housing finance in Australia. It is based on examining secondary material as well as interviewing 11 financial sector experts located throughout the housing finance sector and whose institutions are listed below. Semi-structured interviews were carried out with them as heads, or senior representatives, of their institutions about how financial institutions are mitigating their risk in granting housing credit and whether the obligations in the new legislation will be of sufficient force to limit irresponsible lending⁴.

¹ While there are considerable similarities in lending practices in Australia and the USA, nevertheless, the Australian market did stand apart from the USA when it came to a particular type of irresponsible lending, subprime mortgages.

² The Financial Sector Union represents 50,000 members employed in the financial sector, with the majority in the big four banks (FSU 2009b).

³ Banks as Authorised Deposit-taking Institutions are regulated by the Australian Prudential Regulatory Authority. Non-bank lenders do not take deposits and therefore are not prudentially regulated. Both ADIs and non-ADIs have recently come under the supervision of ASIC through the Act.

⁴ Noteworthy is the fact that those interviewed requested that their institutions' names be used rather than their own and in the case of government bodies that their comments be off-the-record.

The institutions the interviewees were selected from are involved in regulating and monitoring credit providers; mediating disputes between credit providers and customers; representing the interests of bank, non-bank lenders and employees; protecting consumer interests and carrying out research on the financial sector, namely:

- government regulatory bodies - Reserve Bank of Australia [RBA], Australian Securities and Investments Commission [ASIC],
- dispute resolution bodies - Financial Ombudsman Service [FOS], Credit Ombudsman Service,
- financial sector representative bodies – Mortgage Finance Association of Australia, Australian Bankers' Association [ABA], Financial Sector Union [FSU],
- consumer protection – Consumer Action Law Centre,
- academic - Australian Centre for Financial Studies.

Following on the earlier paper by Tomlinson and Burke (2012a), which described how lenders 'manage risk' in delivering housing finance, as well as putting forward a range of reasons why the Australian housing sector withstood the GFC, the intention of this paper is to continue to sharpen the picture around housing finance lending practices in Australia as a means of better understanding their consequences for consumers in terms of risk, indebtedness and house prices.

2. Australia's growing housing indebtedness

De-regulation of Australia's financial sector began in the mid-1980s and since then the country has gone from being one of the OECD countries with the lowest level of household debt to one of the highest (Berry 2010; Burke & Hulse 2010). The ratio of household debt to disposable household income has trebled over the past 20 years, primarily due to an increase in housing debt (Yates and Berry 2011, p. 1141). In 1990 housing debt accounted for 70% of total

household debt but had risen to 90% in 2010 (Yates 2012, p. 84).

Further confirmation about debt levels comes from the RBA when it reports that Australia's household sector has a debt to annual disposable income ratio of 150%⁵ and states in its most recent *Financial Stability Review* (2012) that the household sector is "quite indebted" (p. 45). Surprisingly, it also argues that this high degree of indebtedness does not pose a significant problem as, "there is only a small share of very highly geared borrowers" (p. 45).

Notwithstanding the RBA's position on the seriousness of over-indebtedness, housing debt has resulted in an on-going discussion amongst academics, rating agencies and others.

Ramsay and Sim (2009) report that between 1990 and 2008 there was a 261% increase in the number of personal insolvencies in Australia and that an important aspect of this rise is that it has become an increasingly middle class phenomenon⁶, with new insolvents being older, increasingly from higher-status occupations and with higher levels of personal and household income. In a 2010 ABC News radio interview, Ramsay further states that, "unsustainable home loans have been a major cause of bankruptcy among the middle class".

Another view is that, "In Australia, mortgage stress⁷ has become more visible in the wake of the long boom in housing markets in many regions, especially capital cities. The strong demand for housing, its limited supply, and easily accessible credit have seen household debt levels rise over the last decade, as housing affordability has dropped. This leaves many Australian households vulnerable to interest rate rises and unemployment, or underemployment" (Berry *et al.* 2010).

In September 2011, Moody's Investor Service announced that, "the ability of Australian homeowners to keep up with their mortgage payments has declined over the past year despite the strength of the economy..." (2011b). It noted that a key predictor of the ability to maintain mortgage repayments within each of Australia's

housing markets was the level of equity a borrower has in their home. Home buyers in more expensive housing areas have more home equity due to larger down-payments than regions with cheaper housing, and where borrowers borrow more against their home. Fitch Ratings has also highlighted problems with households getting behind in repayments, however, it found that this situation, "was surprising given the interest rate environment – including two interest rate cuts by the Reserve Bank at the end of 2011 – along with low unemployment levels" (*Age*, 27 March 2012).

One reason this is a hard issue to come to grips with is because national figures on repossessions are unavailable. Both the Australian Prudential Regulatory Authority and the RBA track the number of houses foreclosed on by the banks, but neither of these organisations disclose the figures to the public. In addition, the Australian Bureau of Statistics does not collect figures on repossessions. Forced sales, however, may be an even better indicator of the housing market's health as they far exceed repossessions⁸.

The issue, in fact, may not be whether housing arrears and repossessions have become a cause for concern. Compared with other Western nations, for example, USA and UK, housing arrears are relatively low (Australian Government 2011, p. 129). Rather it may be the fact that certain segments of the population are increasingly worried about their rising debt levels.

Veda Advantage (2012), the largest credit data source in Australia, in its bi-annual *Australian Debt Study Report*⁹ reveals that 81% (four out of five) of those surveyed were worried about meeting future debt repayments.

3. Factors with the potential to contribute to 'irresponsible' lending

Tomlinson and Burke (2012) noted that deregulation from the mid-1980s onward provided an environment for an influx of new housing finance providers. As competition increased amongst them, they became increasingly more flexible

⁵ In 2001 mortgage debt in the U.S. was equal to 73% of income (Green and Wachter 2007, p. 21).

⁶ During the interview with FOS it was pointed out that it is the older borrower who refinanced their house in order to purchase investment property who are showing the greatest indebtedness.

⁷ A common benchmark is the "30/40" rule that says housing affordability is compromised when households in the bottom 40 per cent of income distribution spend more

than 30 per cent of their household income on housing, adjusted for household size (Yates and Milligan 2007).

⁸ Forced sales are properties offered into the market, in contrast to a bank repossessing its outstanding mortgage.

⁹ Telephone interviews were conducted by the Galaxy Research Group with 1,052 people distributed throughout Australia.

(some would say lax) in terms of their lending practices. Borrowers were able to bridge affordability gaps, which previously would have precluded them purchasing a house, by accessing mortgage loans with much higher loan to value ratios than had previously been the norm. Moreover, a range of lending instruments were developed that could address the issues of irregular income and impaired credit history¹⁰.

From the lenders' side, any risk arising from such flexibility in their lending practices can be largely mitigated through the use of variable interest rates and reliance on the use of lender's mortgage insurance, a privatised vehicle that protects mortgage lenders from default. Australia's legal system places full recourse for residential mortgages onto the borrower, allowing the lender to attach immovable assets, as well as other assets owned by the borrower. In addition, lenders have used securitisation to move loans off of their books, further reducing their risk. And where borrowers do go into default banks in Australia have traditionally been much more likely to practice forbearance than what occurs in the USA (Tomlinson 2012b).

Risk mitigating practices that have placed much of the risk onto the borrower were acknowledged as being the case by all those interviewed. Understanding where the risk from lending is located should therefore provide a basis for understanding why lenders may feel free to adopt additional practices that can result in customers becoming over-indebted. Three practices, the setting of lending targets, the use of technology aimed at determining which borrowers are likely to take on additional credit and how sufficient repayment income is benchmarked are described below.

3.1 Banks' sales and bonus culture

A 2009 Parliamentary Joint Committee on Corporations and Financial Services Inquiry into Financial Products and Services heard about a systemic Sales and Bonus culture within the financial services industry (FSU, *Media Release* 4 September 2009a). Based on a pay model that measures bank employee performance through the volumes of debt sold to customers, it also applies to the rewarding of risky short-term behaviour by executives in

the finance sector (FSU *Better Banking*, June 2010; Interview FSU).

More specifically, contracts are built around variable pay rates. Employees earn a fixed base salary but are then given variable sales targets to increase their earnings above the base rate. The system operates so that when targets are achieved bonuses or pay increases are granted and when targets are not met then staff will suffer financial loss along with heightened job insecurity (FSU, *Consultation Paper 115 Responsible Lending*, 2009b, p 2). Within the financial sector, both the selling of debt products and financial services are used to make up pay targets. As a debt product, mortgage lending counts both in terms of the volume and amount written up (Interview FSU).

Noteworthy is the fact that these practices apply to both the banks' in-house employees as well as external mortgage brokers¹¹, who work on commission based on their success in driving customers to the banks they are aligned with. As one interviewee stated, "Irresponsible lending is more likely to occur where income depends on the number of loans granted" (Interview Australian Centre Financial Studies). Moreover, contrary to what one would expect, during the GFC, bank employees were expected to sell more debt products in order to qualify for their basic salary and keep their jobs (FSU *Media Release*, October 2009c. Interview FSU). The reason for employing such a remuneration model is to help a financial institution's bottom line (Interview FSU) and banks' (before tax) profits have grown consistently since the GFC, from \$22.6 billion in 2008 to \$31.9 billion in 2011 (KPMG 2011), making them the most profitable in the world (BIS 2012).

Research carried out by the FSU on Australian bank customers and employees to determine levels of satisfaction and concern around bank practices revealed that a third of bank employees, "are uncomfortable about their customers' ability to meet their financial obligations if they take the new debt products they are being forced to sell them" (FSU 2010, p. 1 - 2). While the FSU research does not reveal how much of the increased debt is specifically due to mortgage lending versus, say, credit card debt and other types of lending, it is clearly the case that there was a strong message coming through about the fact that aggressive

practices contribute to unmanageable debt levels for certain bank customers.

3.2 Targeting debt-prone clients

Recently revealed is the fact that banks are targeting customers with financial products at a time when they are most vulnerable. These are the findings of a research project jointly carried out by the Consumer Law Action Centre and Deakin University (Harrison 2012).

In the past customer data has predominately been used to serve the interests of both consumers and lenders. In recent years, however, there has been a focus towards the segmentation of customers (a way of identifying consumers who are more likely to be interested in a particular product) as a marketing exercise, rather than a risk assessment exercise. Banks use personal information to identify not only individual's needs but also their vulnerabilities. They are, for example, able to target credit offers to those who do not pay their full balance within the interest-free period (Harrison 2012).

Harrison found a segment of consumers demonstrated a willingness to take on more credit, including the consolidating¹² of debts and the refinancing of loans when they found themselves unable to meet current repayments. "Similarly, certain borrowers can be encouraged to re-draw additional funds, or to otherwise refinance or increase the amount of their mortgage" (Harrison 2012, p. 8). Banks pursue such practices because the most profitable customers are not the loyal pay-in-full customers but the ones who do not pay all of their statements during the interest-free period or increase their mortgage, generally at a higher interest rate. From the banks' perspective, there is an element of profitability that arises due to the fact that they are able to charge a risk premium on interest rates for borrowers who are in arrears. Harrison states that, "While the risk of borrowers defaulting, at least in the short to medium term, is a key consideration for lenders, financial counsellors and community lawyers believe that many more consumers who don't actually default are caught in long-term debt, struggle to make payments or are 'trapped' into credit products which are profitable for the lender but inappropriate for the borrower" (pp. 6 - 8).

¹⁰ While it was generally agreed by those interviewed that it was the non-bank lenders that provided the bulk of the loans to people with impaired credit histories, others were of the view that because non-bank lenders were more flexible in their lending practices during this period, retail banks were driven to lower their lending standards in order to become more competitive with the non-bank lenders (Interviews FOS, MFAA).

¹¹ 43 per cent of the lending business is carried out through mortgage brokers (Interview MFAA).

¹² Credit card debt may be rolled over into mortgage debt as a way of consolidating loans.

That such practices should raise concerns is addressed by both Berry (*et al.* 2010) and Veda (2012). Berry found that households use various strategies to prevent the loss of their homes when they are unable to meet repayments, with the most common response of those surveyed being the taking on of more debt, including borrowing on credit cards (40%) and refinancing their loans (24%).

Veda (2012) found that, in addition to the fact that people were struggling to repay their loans, 44% said they would borrow more, while 15% said they would do this by increasing their mortgage loan. Commenting on an earlier survey a Veda Senior Advisor states, "It is concerning that there are people struggling with current debt levels but are turning to more credit as the answer, potentially edging closer to a debt spiral" (Veda 2011).

And, similar to the argument made about the thinking behind the Sales and Bonus culture, Harrison emphasises a similar point, that is, "The competitive need of corporations to increase their profitability and return to shareholders unsurprisingly drives them to use personal information and new technologies for their ends, rather than to help consumers assess the most appropriate products for their needs" (Harrison 2012, p. 8). The use of such technologies therefore becomes a means to an end.

3.3 Issues around how repayment capacity is determined

An additional practice that has the potential to work to the lenders' advantage, but can result in over-borrowing, is the way repayment capacity is determined. Banks have an obligation to determine whether borrowers have the ability to service their debt once they have met their outstanding living costs. Bank calculators located on retail lending institutions' websites are a tool for potential customers to use in determining how much they may qualify to borrow.

Throughout the interviews, when questioned more closely about the method banks use to

determine repayment capacity, the Henderson Poverty Index [HPI] was repeatedly pointed to as the rule-of-thumb benchmark lenders rely on to determine affordability¹³. The HPI provides lenders with a weekly allowance for determining the cost of food, clothing and other necessary living expenses to ensure borrowers remain above the poverty line. This allowance varies depending on the size and type of household, for example, single, two adult with/without dependents and so on (Melbourne Institute of Applied Economic and Social Research 2012). Once the allowance is determined it is then deducted, along with taxes and Medicare, from gross income¹⁴. The amount left will then have a buffer added to it, approximately 1.5 – 2%, to provide for unexpected increases in say, the interest rate (Interview FOS).

The question raised by this method is whether ensuring that a household income is just above the poverty line does not underestimate living costs, particularly in periods of rising interest rates and utility and transport costs. Nevertheless, relying on the HPI as the benchmark will result in borrowing capacity being maximised and therefore profitability for lenders increased¹⁵. As the representative from the FOS, one of the schemes set up to resolve disputes between consumers and financial service providers noted, the lenders view is generally, "to get the mortgages out and worry about the consequences later on".¹⁶ In a recent address to the Australian Mortgage Conference, the Head of Financial Stability at the RBA stated that it is the serviceability, or capacity to pay, dimension, that, "is the crucial decision of how much to lend. And, I think it is the decision point where it is all too easy to become complacent and lend too much" (Ellis 2012).

In sum, while it is not within the scope of this paper to substantiate whether, and to what degree, any of the above practices are being undertaken by individual lenders it is the case that where such practices are applied there is the potential for over-borrowing to occur, which can result in over-indebtedness. The banks' Sales and Bonus culture encourages it, computer

technology promotes it and repayment capacity assessment benchmarks legitimise it.

4. The National Consumer Credit Protection Act (2009)

4.1 Background

Concerns about banking practices are regularly reported in the press, for example, the collapse of Storm Financial that exposed practices such as sales targets and excessive executive remuneration and which became one of the impetus¹⁷ for change in financial services (FSU 4 Sept 2009a; Interview FSU). In 2008, the Council of Australian Governments agreed that the Commonwealth would assume responsibility for the regulation of consumer credit, which had previously been regulated through a Uniform Consumer Credit Code [UCCC] administered by the States and Territories. The key legislation is the National Consumer Credit Protection Act (2009) [the Act], which includes Schedule 1, the National Consumer Credit Code [the Code].

The Act regulates those types of credit covered by the Code, which includes mortgage lending. It obligates credit providers (lenders) and credit assistance providers (brokers) to be licensed by ASIC. Licensees are required to observe general conduct requirements including disclosure and responsible lending practices and to be members of an External Dispute Resolution [EDR] scheme having the power to order change to the terms of a contract¹⁸.

Chapter 3: responsible lending

The earlier UCCC did not have a direct responsible lending obligation. Chapter 3 of the new Act imposes a responsible lending obligation¹⁷ on all credit licensees. The Act obliges licensees to carry out three steps in assessing whether or not credit is suitable for a particular consumer, namely:

- conduct 'reasonable'¹⁸ inquiries about the consumer's financial situation, requirements and objectives,

¹³ A benchmark was established by the Henderson Poverty Inquiry in December 1973. The Melbourne Institute of Applied Economic and Social Research updates the poverty line for Australia on a quarterly basis.

¹⁴ Banks calculate gross income in different ways, e.g. how they count bonuses.

¹⁵ Recent notices in the press have alerted the public that some of the major banks would be changing their serviceability calculators in February 2012, moving away from using the HPI to the Household Expenditure Measurement (HEM) which provides a more realistic figure in certain cases.

¹⁶ The FOS for Authorised Deposit-taking Institutions and the COS for non-bank mortgage lenders.

¹⁷ ASIC has published regulations, RG 209 Credit Licensing: Responsible Lending Conduct.

¹⁸ 'Reasonable' is not defined in the Act; the expectation is that case law will clarify its meaning.

- take 'reasonable' steps to verify the consumer's financial situation,
- based on these inquiries, assess whether the proposed credit contract is not 'unsuitable' for the consumer, that is, does the consumer have the capacity to repay the loan without 'substantial hardship'¹⁹.

Lenders are required to demonstrate that they have adequate policies, arrangements, systems and processes in place to ensure that the above steps are carried out. For example, under the previous UCCC, lenders were not required to investigate what a borrower intended doing with the money, where under the Act they are.

Reasonable inquiries about a consumer's financial situation include inquiring into:

- quantum and source of income,
- fixed and variable expenses,
- nature and value of assets,
- credit history,
- circumstances such as number of dependents,
- foreseeable changes in circumstances (RG 209).

Reasonable steps to verify specific information include examining:

- PAYG, recent payroll receipts/payslips and confirmation of employment with employer,
- income tax returns, business activity statements, statements from consumer's accountant for self-employed persons,
- credit reports.

While lenders may have in the past made inquiries into the potential borrower's financial situation and taken steps to verify it, they have not, up to now, had to assess whether the credit contract is 'not unsuitable'. It is in carrying out this step that the lender must assess whether the consumer will only be able to comply with the contract's repayment obligations through 'substantial hardship'.

For example, having to fund a loan out of cash flow could result in a borrower being denied a loan if he/she is relatively close to retirement age. An older borrower wanting to access a 30-year mortgage would need to demonstrate

capacity to service the loan for the entire term in order for it to be deemed 'not unsuitable' (ACFS 2010). Moving the assessment of whether 'substantial hardship' will occur into the Act, rather than waiting for a dispute, as occurred under the UCC, moves the responsible lending obligation up-front in the process, rather than after the fact as was previously the case (Interview ABA).

If a dispute does arise, the EDR schemes will review a lender's decision-making processes (after-the-event) and determine whether there has been 'maladministration' in the process (for example, a failure to verify the customer's financial situation). It cannot, however, overrule the lender's commercial decisions (Interview FOS; Interview ABA).

Chapter 2: Licensing of persons who engage in credit activities

Section 47 sets out general conduct obligations of licensees, including having in place adequate arrangements to ensure that clients of the licensee are not disadvantaged by any conflict of interest that may arise wholly or partly in relation to credit activities (1) (b). Key to the compliance obligations is the fact that a credit licensee is responsible for deciding how to comply with them, which in a nutshell means having in place measures to ensure compliance occurs (RG 205.8).

Whether arrangements are 'adequate' will depend on the particular circumstances. In the case of a credit provider paying a licensee providing credit assistance a higher rate of commission for achieving a certain volume of sales, the licensee would need to adopt adequate arrangements to ensure that consumers are not disadvantaged by the possible conflict of interest that arises.

The Act is supervisory in its approach, which is in contrast to the stricter regulatory approach adopted in the recently passed Corporations Amendment (Future of Financial Advice) Act 2012, which introduces a ban on conflicted remuneration, including commissions and volume-based payments in relation to advice given to retail clients. Whether the former approach will be sufficient to limit the Sales and Bonus culture it is too early to tell. An article in the *Sunday Telegraph* (16 October 2011) highlights the fact that the big four banks' staff were still

being offered Christmas bonuses to push more loans to customers, including convincing customers to roll their credit card debt into their mortgage loan.

4.2 Some additional issues

Credit reports

The Privacy Act No. 119 of 1988 and Credit Reporting Code regulate what type of information can be kept, how long it can be kept and who can access the information. Currently credit reports only provide personal information, applications for credit over the last five years and defaults, court judgements (five years) and bankruptcy (seven years). Such information may, or may not, provide warning signs to potential lenders. Veda (2008) revealed that the majority of people that went bankrupt (57%) had a 'clean' credit record at the time. 'They were very likely to be granted yet more credit because their file did not provide any warning signs of financial trouble' (Veda 2012b).

Because credit reports do not provide adequate information about borrowers, the Privacy Amendment (Enhancing Privacy Protection) Bill 2012 has gone before parliament in a move to extend consumer credit reports. Credit reports would be able to demonstrate: when an account was opened and closed; what the current credit limit is; what type of credit was offered; and an accounts repayment history over the previous two years, where a consumer is late making the minimum payment on loans (Veda 2012b). Hence, there will be a time lag during which the credit report currently available to lenders is a less than adequate source for determining a potential borrower's debt situation.

Repayment capacity benchmarks

As previously stated, in addition to examining financial data, licensees are expected to develop appropriate systems and processes to identify whether a proposed credit contract is likely to cause 'substantial hardship' to a consumer' (RG 209.65). The regulation recommends applying benchmarks as tools that are useful in determining whether a particular consumer will experience 'substantial hardship' as a result of meeting the obligations of the credit contract. Such benchmarks could assess whether a consumer's disposable income is:

¹⁹ 'Substantial hardship' is not defined in the Act; the expectation is that case law will clarify its meaning.

- below a level where they do not have funds to meet their realistic living costs and those of their dependents,
- below an amount based on a particular objective indicator (e.g. the Henderson Poverty Index plus a certain margin),
- below the maximum applicable level of government benefits for a person in the financial and family situation of the consumer (RG 209.66).

The fact that the Henderson Poverty Index is put forward in the regulations as the recommended benchmark for assessing whether a potential borrower has the capacity to repay a loan is disconcerting because of the potential to over-estimate as previously described.

4.3 Response to the Act

When those interviewed were asked to respond to the Act, it was generally welcomed as an important step forward in improving consumer protection due to its introduction of standards of conduct to encourage prudent lending. Highlighted was the fact that ensuring that the mortgage contract is 'not unsuitable' for the borrower has now been shifted onto the lender, where before it sat with the borrower.

Interestingly most of those interviewed were also of the view that its main impact would be on the non-bank lenders, who will now be required to be licensed and adhere to responsible lending obligations. Some of those interviewed, including the ABA representative pointed to the fact that the banks believed that their lending practices are already covered in the Banking Code of Practice²⁰, which has provisions relating to credit decisions. The representative of the non-bank lenders did, however, point out that since the GFC there had been a significant shrinking of this sector, which has resulted in banks carrying out 94% of lending today, causing him to speculate that the competition for customers will in future more than likely occur amongst banks rather than between the banks and non-bank lenders (Interview MFAA).

Those interviewed noted that the Act will do away with certain types of predatory lending that had occurred previously, for example, the granting of 'no doc' loans, reliance on assets to meet loan repayments, pressure to make false

declarations on application forms and as well as to sign documentation without proper explanations and so on. At the same time, it was pointed out that any gaps in the legislation would only be revealed once it had been in operation for a few years. Before such time the author would argue that a reading of the Act already reveals that certain practices contributing to over-indebtedness have been unacceptably dealt with. With respect to obligations on lenders, it is clearly the case that the Act focuses primarily on the 'process' lenders follow in granting credit rather than on the specific 'practices' they rely on in the lending market.

5. Conclusion

Over the last decade many households entered the Australian property market hoping to benefit from an almost unbroken increase in house prices. Lenders have increasingly competed for this house buying market. With much of their risk mitigated, in particular by forcing consumers to take out insurance that does not insure them but insures the lender against them defaulting, they have felt confident in pursuing practices that have led to increased profits, but also had the potential to lead to over-indebtedness on the part of borrowers, in particular more vulnerable borrowers.

This paper has examined whether practices such as the Sales and Bonus culture, targeting debt-prone clients and assessing a potential borrower's capacity to repay a loan using a benchmark that is based on living costs remaining just above the poverty line, should be viewed as factors warranting better understanding as to their ability to impact on household over-indebtedness. Moreover, whether such practices encourage, promote and legitimise lenders' actions.

The author would argue that to date there may have been too much reliance on official statistics, for example, housing arrears and other macro indicators to assess the seriousness of over-indebtedness. Not enough attention may have been given to understanding the inner workings of the lending institutions, and how important the more micro issues are when it comes to understanding the amount of housing debt borrowers take on and ultimately, until recently, the continuing rise in house prices.

Finally, this paper highlights a concern that certain practices that may be contributing to over-indebtedness have not been suitably taken into account in the new credit legislation, with its emphasis rather on the 'process' of maladministration. Whether consumer protection has been sufficiently extended through the legislation will only become apparent in due course.

The debate about the seriousness of housing debt will continue to shift back and forth, and periodically fresh indicators will become available to fuel these discussions. Australia's economy, being strongly tied to China's industrial demand, makes it continually vulnerable to external volatility. If another major shock occurs, then demand will fall and unemployment will rise; over-indebtedness could rapidly translate into increased housing arrears, rising defaults and housing market deterioration. Government could, however, repeat actions it took during the GFC by managing both monetary and fiscal policy in a way that prevents such a scenario from playing out. That said, research on personal insolvency reveals it has been rising in both good and bad economic times, suggesting the jump is not necessarily due to economic conditions at the time (Ramsay and Sim 2009). And while the interview with the FOS representative revealed that it is not seeing a lot of actual defaults at this point in time, it is clearly seeing large amounts of rising over-indebtedness which has led it to increase its staff in preparation for an increase in disputes between borrowers and lenders.

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²⁰ Clause 25.1 - Before we offer or give you a credit facility (or increase an existing credit facility), we will exercise the care and skill of a diligent and prudent banker in

selecting and applying our credit assessment methods and in forming our opinion about your ability to repay it.

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Mortgage credit and fiscal benefit in the Netherlands

↳ By Fred Pallada and Hans Mersmann

1. Introduction

In the Netherlands as well as in other countries the housing market is in a state of crisis as a result of the recession that struck the western economies in 2008. Prices are down, saleability has diminished and house building has practically come to a standstill. As this is to the detriment of consumption and employment, various measures have been put forward recently by politicians, academics and experts in order to revitalize the housing market. Among the proposed measures, the abolition of fiscal incentives for owner-occupiers is mentioned time and again. Since 1914 fiscal stimulation of homeownership has been achieved by considering the owner occupied dwelling as a source of income. In that respect interest payments on mortgage credits are, as costs of investment, deductible from taxable income. Many people think that this relief is in favour of the high income brackets and want to pour cold water on the scheme. We do have our doubts about this point of view because when one considers the facts, the suggestion seems to be unfounded. Moreover, what precisely are high incomes is not always specified so the pros and cons fall prey to a lot of emotive argument.

In this contribution, we first want to investigate to what extent the various income groups do benefit from the income tax relief. Secondly, we will distinguish the low income brackets from the high income brackets in a more coherent way, and finally we will give a judgement on the fairness of the scheme. In order to concentrate on the main issues in the income tax system, assumptions are inevitable as it is our aim to bring the relevant

facts together in a manageable model that will serve as a guide to this controversial matter.

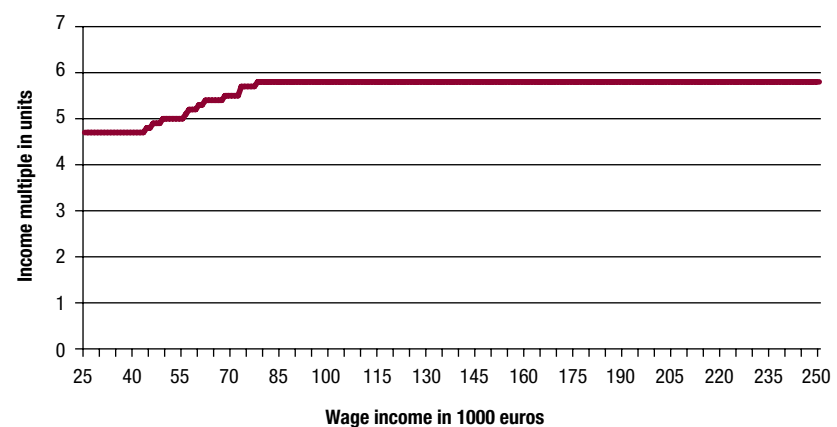
2. Assumptions

To shine more light on the question of preferential fiscal treatment of high incomes, a more basic approach has been chosen. For various income levels we calculate the income tax, which has to be paid with and without a mortgage credit. Then it is obvious that the difference in outcome is caused by the interest payments on the mortgage credit. The practicability of this approach requires that a number of assumptions

are made. Given the wage income of a borrower, the maximum affordable mortgage debt in the Netherlands is determined by the National Institute for Family Finance Information. This is done by providing the annual home expenses standards, which is an affordability index. For all incomes at five interest rate levels, the maximum borrowing capacity can be derived from these standards. Given the prevailing interest rate it is expressed as a multiple of the gross annual income. The multiple is higher as the income goes up, see figure 1.

Half of the debt concerns an annuity mortgage. This is a common type of mortgage supplied

Figure 1 Borrowing capacity with interest rate of 4%



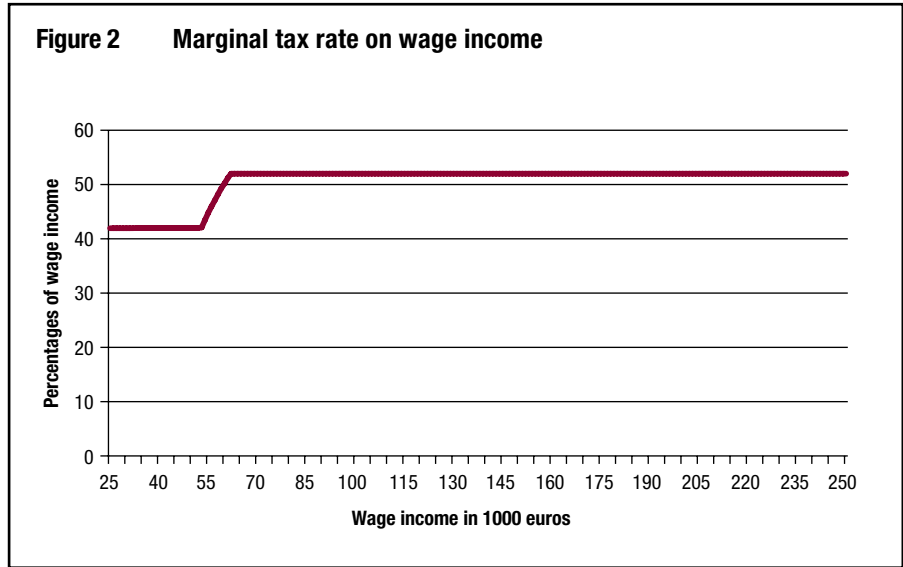
¹ An annuity is a fixed amount which periodically has to be paid during the term of the loan. Annuities consist of two parts. One part is interest payments on the loan and the other one is remittance of the loan. The remittance increases progressively during the

term of the loan which means that at the same time the interest payments decrease progressively.

in cases where the borrower is eligible for the National Mortgage Guarantee in The Netherlands. The mortgagor has to pay interest and to redeem the mortgage according to a fixed amount periodically. The other half will be redeemed at the end of the term.¹ On both parts the interest is tax deductible over a loan maturity of 30 years. For newly issued mortgages as of 2013, tax is only deductible for mortgages paid back in 30 years. Mortgage rates currently vary from 3 to 5%, depending on the years that the interest rate has been fixed. So it is possible to have a variable interest rate, or quite commonly, rates fixed for 10 years.

The calculations are based on the average of these. The consequences of these assumptions for the taxes, premiums and mortgage interest deduction are presented as an average over the entire duration, calculated in relation to the income and the tax regime in 2012. Income consists only of earned income and an employer contribution for the Health Insurance Act. Every taxable person, regardless of whether he has an income from work, or from another source, has a claim to the general tax rebate. The calculations are performed for a single earner with a cohabiting partner. It does not take into account the tax deduction of transaction fees.

To set against the deduction for interest payable on taxable income, the owner-occupier should add to his income an imputed rental income from his property. The tax collector considers that living in one's own house is the same as renting your own house, and thus is seen as taxable income. Basically a homeowner has to pay a rent to himself. This so called 'rent' is called 'imputed income from owner occupation' and is a percentage of the property value. Imputed income is 0.52% of the property value up to an amount of € 1.02 million. Above that limit the rate varies progressively in relation to the value of the property. Mortgage interest is deductible according to the Income Tax Law 2001 insofar as it exceeds imputed rental income from owner occupation. Therefore, the term 'interest deduction' is increasingly referred to as the amount by which the mortgage interest paid is greater than the imputed rental income from property. Figure 2 shows how the marginal tax rate varies with the level of income. The highest marginal rate is 52% which is already being achieved at an income of € 62,000.²



3. Interest deducted and tax advantage

Using some elementary calculation rules, the interest deducted and the related tax benefit can be resolved to the underlying factors. This formal approach serves as a blueprint for all income levels but as we proceed we will work out numerical examples for the households of, respectively, 'Alec', 'Bill' and 'Cole' in order to facilitate understanding. The average yearly interest payment on the mortgage debt can be written as,

$$(1) \quad i = w \cdot y \cdot g \cdot r$$

where

i = average interest paid on the debt in euros on a yearly basis

w = debt-to-income ratio according to the home expenses standards

y = earned income

g = ratio of average debt to initial debt in percentage/100

r = interest rate in percentage /100 per year

So, if the maximum affordable mortgage debt of Alec is 5.8 times his income ($w=5.8$) at an income level (y) of € 85,000, his initial mortgage debt ($w \cdot y$) is € 493,000. However, the average debt is smaller than the initial debt because repayment happens in the course of time. Given the assumptions, the average debt is 80.6% ($g=0.806$) of the initial debt, which amounts to

Table 1: Numerical elaboration of the model, part I

Person	income per year (y)	affordable index (w)	initial mortgage (w*y)	average/initial loan (g)	average debt (w*y*g)	interest rate (r)	av. interest payment (i=w*y*g*r)
	euro	multiples	euro	%	euro	%	euro
Alec	85,000	5.8	493,000	80.6	397,461	4.0	15,898
Bill	58,000	5.2	301,600	80.6	201,552	4.0	8,062
Cole	32,000	4.7	150,400	80.6	121,254	4.0	4,850

² For each income level the marginal effective tax rate is obtained by relating the additional tax payment in euros for an income increase to this additional income after which the result is multiplied by 100%.

Mortgage credit and fiscal benefit in the Netherlands

€ 397,461 ($=0.806 \cdot 493,000$). With an interest rate of 4% ($r=0.04$) it is easy to see that Alec's average yearly expenses on mortgage interest (j) is € 15,898. Compare this with the position of Bill who has an income of € 58,000 with a related affordable index of 5.2. His mortgage debt is limited to € 301,600 so that with the same g -ratio his average debt is € 201,552 ($=0.806 \cdot 301,600$). As Bill's interest rate on the mortgage debt is 4% as well, his average interest payment is € 8,062 a year. In table 1 these outcomes are put together in a systematic way where also the results for Cole have been added. Cole earns less because he has just entered the labor market and is consequently faced with the lowest affordable index of 4.7.

For calculating income tax, the imputed rental income from owner occupation has to be added to the gross annual income. The property value is simply supposed to be proportional to the initial mortgage debt. Therefore the calculation rule is,

$$(2) \quad b = e \cdot w \cdot y$$

with

b = Imputed rental income from owner occupation, in euros per year

e = Imputed rental income from owner occupation as a percentage/100 of the property value

For Alec as well as for Bill and Cole the imputed rental income is 0.52% of the property value. So, for instance Alec has an imputed rental income

of € 2564 ($=0.52 \cdot 493,000/100$). In accordance with the above definition, the interest deduction is the difference between interest paid, i , and imputed rental income for owner-occupancy b :

$$(3) \quad a = i - b = w \cdot y \cdot g \cdot r - e \cdot w \cdot y = w \cdot y \cdot (g \cdot r - e)$$

where

a = average mortgage interest deduction in euros per year

The fiscal benefit as a result of mortgage interest deduction is obtained by multiplying this deduction with the marginal tax rate, which gives us equation (4).

$$(4) \quad f = a \cdot t = w \cdot y \cdot (g \cdot r - e) \cdot t$$

with

f = fiscal benefit in euros per year

t = marginal tax rate without interest deduction in percentages/100

To continue the numerical example, as shown in table 2, Alec ends up with an interest deduction of € 13,335 and as his marginal tax rate is 52% ($t=0.52$) he realizes a fiscal benefit of € 6,934.

For Bill who has a marginal tax rate of 48.2% the fiscal benefit is € 3,130 whereas Cole with a marginal tax rate of 42.0% realizes a modest result of € 1,707. Equation (4) makes clear which factors lead to the fiscal benefit in this table. As

the amortization scheme (g), the interest rate (r) and the imputed income (e) are the same for everyone; the differences in the results are a function of the affordability index (w), the income level (y) and the marginal tax rate (t). Although the variables w and t are positively correlated with the income level, we can treat them as exogenous to the model.

What we can conclude now is that, measured in euros, those taxpayers with high incomes benefit more from the mortgage interest deduction than those with low incomes because of a higher borrowing capacity (w) and a higher marginal tax rate (t). In the opinion of some people this should be seen as an unfair advantage for those on higher incomes, or as an unfair disadvantage for the less better off. Should we agree with this point of view? It cannot be denied that Alec's benefit is four times as large as Cole's, but does this necessarily mean that it is unjustified? At first sight we do not think so because it does not make sense to compare the fiscal benefit in terms of euros when unequal incomes are at stake. Examples of unequal outcomes, which are acceptable to a lot of people, can easily be given. For instance, one household gets € 1,000 interest on its savings account, whereas another household at the same time receives € 250 on its account because it has deposited only a quarter of the amount of the first household. Making a judgement just by counting the euros while disregarding the size of the investments, does not make sense. Only by taking into account the money both households have deposited can one conclude who has made the best return on each euro invested.

So, we should not compare the euros, but compare percentages. And this is exactly what we mean by standardizing the fiscal benefit if we want to make a comparison when different incomes are at stake. In our case the obvious standard is the average mortgage credit ($w \cdot g \cdot y$) because it is the very cause of the fiscal benefit. Dividing the fiscal benefit in equation (4) by the average mortgage loan gives us equation (5)

$$(5) \quad \frac{f}{w \cdot g \cdot y} = (r - \frac{e}{g}) \cdot t$$

Now, as a percentage of the average mortgage loan the relative benefit of Alec turns out to be 1.74% ($=6,934/39,7461 \cdot 100\%$) whereas Bill ends with a relative benefit of 1.55% and Cole lags behind with a relative benefit of 1.41%, see table 3. So we can conclude that Alec still benefits at a higher rate, but the differences with Bill and Cole are now less impressive.

Equation (5) has two advantages over equation (4). In the first place, as the right-hand side shows,

Table 2: Numerical elaboration of the model, part II

Person	av. interest payment (i)	initial mortgage ($w \cdot y$)	rental income (e)	imputed rental income ($b = e \cdot w \cdot y$)	interest deduction ($a = i - b$)	tax rate (t)	fiscal benefit ($f = a \cdot t$)
	euro	euro	%	euro	euro	%	euro
Alec	15,898	493,000	0.52	2,564	13,335	52.0	6,934
Bill	8,062	301,600	0.52	1,568	6,494	48.2	3,130
Cole	4,850	150,400	0.52	782	4,068	42.0	1,707

Table 3: Numerical elaboration of the model, part III

Person	fiscal benefit (f)	average debt ($w \cdot y \cdot g$)	rel. fiscal benefit [$f / (w \cdot y \cdot g)$]	interest rate (r)	net interest rate [$rn = r - f / (w \cdot y \cdot g)$]
	euro		%		
Alec	6,934	397,461	1.74	4.0	2.26
Bill	3,130	201,552	1.55	4.0	2.44
Cole	1,707	121,254	1.41	4.0	2.59

the result is independent of the debt-to-income ratio (w) imposed by the National Institute for Family Finance Information. Secondly, the relative fiscal benefit is a neutral concept in terms of percentages. So, the effect of the mortgage interest deduction resulting from various levels of mortgage loans can now easily be compared without any objection. To go one step further we may choose another perspective, namely the net interest rate that we define as the difference between the gross interest rate (market rate) and the fiscal benefit in relation to the debt. Equation (6) gives us the arithmetic where in the most right-hand-side of the equation we have substituted equation (5) for the fiscal benefit in relation to the average debt after which we have rearranged the variables.

$$(6) \quad r_n = r - \frac{f}{w \cdot g \cdot y} = (1-t)r + \frac{e}{g}t$$

Where,

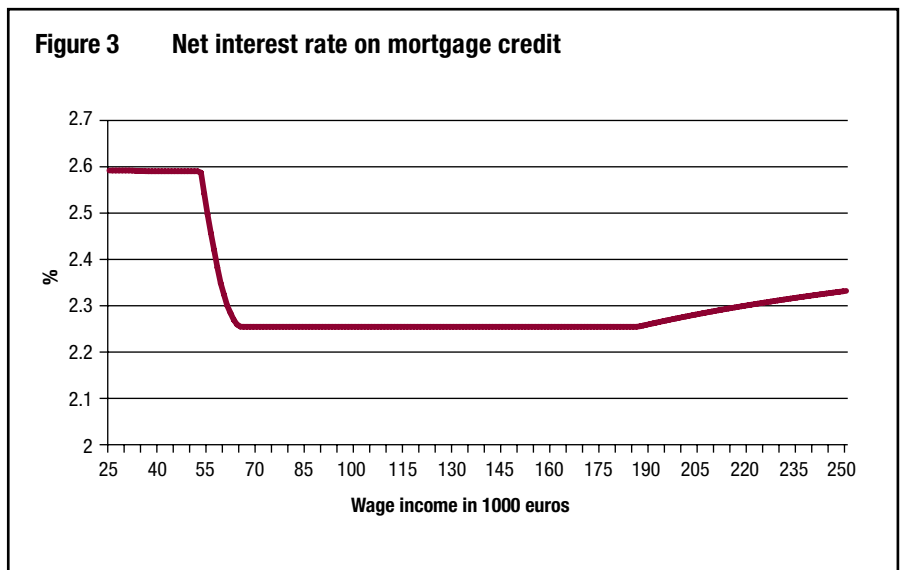
r_n = net interest rate after deduction of the standardized fiscal benefit

From the perspective of equation (6) we can understand the ultimate financing costs of the mortgage in terms of average yearly percentages when we take the fiscal benefit into account. For Alec, Bill and Cole we can directly use the results we have already achieved in table 3 so that we finish our numerical example with the net interest rates as specified in the last column of the table.

4. Relative fiscal benefit for low and high incomes

For judging the net interest rate for different income levels, however, equation (6) is a handy tool. The main thing we need to know for those income levels is the marginal tax rate (t). The interest rate as well as the amortization scheme is the same for all debtors. So r and g show up in the analysis as constant factors with a value of 0.04 and 0.806. And as long as we are willing to disregard incomes above the level of € 186,000 per annum, the imputed income percentage (e) is also invariant (0.52%).³ As incomes above that level are not significant for the Dutch housing market this limitation is not a real problem to the analysis.

Figure 3 shows how with a gross interest rate of 4% per year the net interest rate varies with



income. It turns out that for incomes up to € 53,000 the net interest rate is 2.59% so that the standardized fiscal benefit for incomes to that limit proves to be 1.41%. This means that we can classify incomes in the range of € 25,000 to € 53,000, where Cole's income is situated, as low incomes. For incomes of € 66,000 up to € 186,000 the net interest rate is 2.25%, leading to a constant standardized fiscal benefit of 1.75%. In this range we find the high incomes, amongst which is Alec's. Incomes in the range of € 53,000 to € 66,000 are in an intermediate position and which we consider to be those of middle-income earners, where we can find Bill.

Up to this point in our analysis we can say we have been able to classify the incomes. It needs to be said, however, that we based our calculations on a gross interest rate of 4%. At other interest rates the classification of incomes may shift. A higher interest rate means a lower affordable index and consequently a lower maximum mortgage debt, which of course influences the interest payments as well as the fiscal benefit. We could recalculate the results and see that the borderlines between the low, middle and high incomes will move but that our understanding of the classification does not change dramatically. But for the topic of fairness we have not yet reached a clear conclusion. All we can say is that at an interest rate of 4% the high incomes have at most an extra average fiscal benefit of 0.35% compared to the low incomes. The question whether this is accept-

able is a moral one. Moral statements cannot be proved; they can only be accepted or rejected. This being said we finally want to underline an interesting point, which has been neglected in the discussion about the fairness of the fiscal benefit for owner-occupiers in the low income brackets. We initially assumed that all mortgage credit transactions are closed at the same interest rate. However, mortgages which qualify for the National Mortgage Guarantee Scheme are granted an interest rate discount by financial institutions of at most 0.6 percentage points because guaranteed monetary claims require less capital reserves to be held by the financial institutions. The guarantee runs up for mortgages to € 320,000. Although income is not a limiting factor, the scheme is basically set up to support the low and middle incomes. Equation (6) tells us that for low incomes an interest rate discount of 0.6% point leads to a net interest rate reduction of $(1-42/100) \cdot 0.6 = 0.35\%$ which compensates them for the disadvantage towards the high incomes. So, from this perspective, the idea that the low income group is treated unfairly, is an argument that does not hold water.

5. Concluding remarks

We have succeeded in classifying low, middle and high incomes in a more definite way than we generally encounter in discussions about the fiscal benefit for various income groups as far

³ For dwellings which are acquired with mortgages which are obtained with incomes above the level of € 186000 per annum the imputed income as a percentage of the

property value increases progressively with the property value. This, of course, works to the detriment of the relative fiscal benefit.

as interest payments on mortgage debts are concerned. The presented differences in fiscal benefit expressed as a percentage of the average mortgage debt are small as well as tentative, as the assumptions we made do not hold for everybody in the same way. Besides, these benefits are derived from averages calculated over a period of 30 years under the assumption that incomes will be fixed. In reality people do have

changing incomes over time. Usually they start in the low income brackets and gradually move upwards into the higher ones. Because of this the actual differences in fiscal benefit between two persons during their lifetimes will be less pronounced than the stylized facts of the model suggest. This being said one can nevertheless conclude that the high income brackets do benefit most from the income tax relief for two reasons. In

the first place their tax burden is high compared to the less well off. And secondly, they have a higher affordable index so that they can borrow progressively more than those on low incomes. Nothing is controversial in that, which means that it is our opinion that arguments that those with high incomes are benefiting unfairly from the tax system have to be considered in a less politically driven context.

Affordable housing in Tunisia: challenges and opportunities emerging from the Arab Spring

↳ By Josephine McVitty

1. Introduction

For the past two and a half years, Tunisia has been going through a period of considerable social, political and economic change. Tunisia became the first country to attract international attention in December 2010, during the Arab Spring. A wave of protests and civil unrest resulted in the departure of President Zine El Abidine Ben Ali, ending 23 years of rule. The uprising, fuelled by frustration caused by worsening living conditions, high unemployment, political repression and corruption, inspired a series of similar events throughout the Middle East, which have had long-lasting consequences for the geo-political outlook of the region.

During the Revolution, Tunisians protested against the level of corruption, the lack of political and civil liberties, high unemployment, the rising cost of living and inequalities between regions. The scale of the affordable housing shortage in the region, which has prevented access to first-homes and a reasonable standard of living, contributed to the mounting frustration, especially among the region's youth, which fuelled the uprising. On both the household-level as well as the macro-level, housing plays an important role, with the potential to stimulate economic growth and job creation, support social cohesion and stability in low-income communities, as well as providing solid collateral for growing the nation's asset base and development of capital markets. Housing is also

of primary cultural importance to Tunisians. It is considered integral to dignity, well-being, and future prospects, and as such, it is not surprising that it has become a primary issue on the political agenda, throughout the Middle East.

Under pressure and with high expectations, the Tunisian government has been eager to demonstrate that it is responding to the needs of the population, and ensuring that quality housing is within the reach of struggling households is a central component of this goal. In this context, the government has identified the need for a comprehensive housing policy, effective in the long-term, which paves the way toward improvements in the delivery and financing of housing.

2. Current context

Located in a strategic position at the tip of North Africa, Tunisia is a lower-middle income country with strong potential for growth, as it is poised to act as a gateway from Europe into the Middle East and the rest of Africa. Tunisia has a diverse economy with mature agricultural, mining, tourism and manufacturing sectors, Gross Domestic Product per capita was US\$9,900 in 2012, the Gini coefficient, that measures the level of inequality, is low in comparison to developing countries, measured at 0.40 (2005), while the country is rated "high" on the Human Development Index with a score of 0.712 (2012)¹.

Since the former President, Ben Ali, fled the country, the economy has suffered. Investor panic initially resulted in a reduction in investment, with the growth rate falling from 3.1% in 2010 to -1.8% in 2011. It is finally recovering and reached 3.6% in 2012, with projections of between 3.2 to 3.7% growth in 2013². While the economy may be recovering, Tunisia continues to suffer from high unemployment, at 16.7% in the fourth quarter of 2012, while 33.2% of youth cannot find employment³. The rate of inflation has also been increasing, reaching 5.9% in 2012, and large current account deficits have continued to grow. The deficit stands currently at -8.5%. The IMF has reported that the banks are undercapitalized and have severe asset-quality issues. In the past year, the Moody's ratings have twice been downgraded due to the uncertain future and fragility of the banking sector. At the end of May, the government issuer ratings decreased from Ba1 to Ba2, with an outlook that is negative⁴.

Politically, Tunisia has installed a multi-party system, yet uncertainty and the risk of instability persist. A coalition known as the "National Unity Government" ruled from late January until the first free elections in late October 2011. The Ennahda Movement, a formerly banned moderate Islamist political party, won a plurality of 89 seats out of a total of 217 and formed a coalition with two other parties to make up the interim government, with Moncef Marzouki appointed as President. However, the interim

¹ Central Intelligence Agency, World Fact book: Tunisia, 2013.

² Central Bank of Tunisia, The Economic Situation Periodical. No.98. January, 2013.

³ *Ibid.*

⁴ Moody's Investor Services, Moody's downgrades Tunisia's government issuer ratings to Ba2; outlook negative, 29 May 2013.

Table 1: Summary of key country data for Tunisia

Population	10.7 million
Urban Population	66.3%
Urban growth rate	1.5%
GDP per capita (PPP)	\$9,900
GDP growth rate	3.6%
Inflation	5.9%
Exchange Rate	1 USD = 1.56 Tunisian dinar
Gini Coefficient	0.40
HDI	0.712
Unemployment	16.7%
Youth Unemployment	33.2%

Source: CIA World Fact book, 2012. World Bank, 2012; UN-HABITAT, 2011.

government was collapsed following tensions when the key opposition party leader, Chokri Belaid, was assassinated in February 2013. The current government has now given technocrats control over key ministries such as defense, interior, justice and foreign affairs in order to ease political tensions until the next elections that are intended for late 2013⁵.

The interim government has been given the task of completing the national constitution and setting the stage for the new policy direction of the country. Over-arching national priorities include leading the country through a successful transition period, reducing regional inequalities, job creation and sustained economic development. Housing has been identified as a flagship issue to achieve these goals. This prompted the announcement for an “emergency 30,000 housing program” in January 2012, to replace the precarious housing across the country. Yet, progress on implementation has been slow, and an emergency housing program will not be able to meet all the needs of the population. The Secretary of State in charge of Housing, Madame Bouraoui has emphasized that comprehensive reforms are required to address the structural issues that will create an efficient and functional housing market. Mme Bouraoui asserted at the Jeddah Economic Forum, held in April 2013, that human dignity, as a core component of Islam, is not achievable without a good home.⁶

3. Basic dynamics of the housing market

3.1. Evolution of Housing Policy in Tunisia

Home ownership is a key aspiration for Tunisians, a country with one of the highest rates of home ownership in the world, estimated at close to 80% of households⁷. Since independence from France in 1956, Tunisia has accumulated substantial achievements in affordable housing policies that have involved establishing regulatory frameworks, specialised institutions, and targeted programs. These housing initiatives have been widely lauded throughout the region for their successes.

At first, the Tunisian public sector had a primary role in housing and urban development. Achievements through the 1960s, 70s, and 80s, included reducing the percentage of slums from 23.7% of the housing stock to 2.7% from 1975 to 1994, according to UN-HABITAT’s 2010 State of African Cities Report⁸. Successful policies and programs have supported state enterprises to build over 300,000 low-income housing units, and the percentage of households with access to piped water and electricity has reached almost 100%, those with access to wastewater networks in urban areas is at 85%, and poverty levels dropped from 22% to 3.7%, over the period from 1972 until 2011⁹.

In 1988, the National Housing Strategy marked a policy shift from public provision of housing, toward supporting the participation of the private sector in housing production. Law 17 of 1990 organized the real estate profession, putting in place the regulatory and operational framework for residential development, including registration and compliance standards. Since then, the number of registered developers has grown exponentially to more than 2400 today, yet only a handful of these build beyond a single development, whether that is at the scale of a unit or multi-storey apartment block, and the homes are almost invariably targeted at high-income households, crowding the public social housing enterprises out of the market.

Since the 1990s, through Ben Ali’s regime, innovation in housing policy stagnated, existing tools became less effective and public agencies stopped working as they were intended. The lowest income groups and youth were the first to become exposed to the effects. Today, low-income neighborhoods, or *quartiers populaires*, continue to expand at a greater rate than formal low-income housing can be produced, prices are rising rapidly and over-crowding in inadequate shelters is becoming more common. This reality has fuelled frustration, which has become visible through ongoing protests, strikes and social tensions.

Developing more resilient housing policy is fundamental to a peaceful and successful democratic transition in Tunisia, and the perceived success of an elected government. The following section identifies the key steps in the supply and demand of housing and what aspects need to be addressed to facilitate an improved housing system.

3.2 Existing housing stock and housing production

Tunisia is in the unusual situation for an emerging country where the total number of units exceeds the total number of households. The last census in 2010 recorded 2.12 million households, to a total stock of 2.5 million units¹⁰. The number of vacant units continues to grow, yet this ‘over-supply’ is almost exclusively made up of up-market housing, which function either as secondary homes for high-income families,

⁵ Reuters France, “Des élections avant la fin 2013 en Tunisie selon Ben Jafaar”, 5 March, 2013.

⁶ Jeddah Economic Forum, Panel on “Presenting the Affordable Housing Challenge”, Held 18th March, 2013 in Jeddah, Saudi Arabia.

⁷ Ministry of Public Works Website, 2012.

⁸ UN HABITAT, State of African Cities, 2010.

⁹ *Ibid.*

¹⁰ Ministry of Public Works website: www.mehat.org.tn, 2013.

luxury rental properties for foreigners –particularly Algerians and Libyans, or as speculative investment properties. Hence, housing supply in absolute numbers hides the reality of a supply shortage of housing that is affordable to middle and low-income families, or the youth.

As mentioned in the previous section, the production of housing was once dominated by the public sector. The National Real-Estate Company [SNIT], created in 1957 as an independent state-owned company is responsible for the construction of low or medium-income owner-occupied housing. Until 2006, SNIT had built 260,000 units (60% social, 35% market-rate, and 5% high-income housing). Meanwhile, the Social Housing Promotion Company [SPROLS], also began building housing in 1977, initially as rental properties and later exclusively owner-occupied as they failed to collect rents and evict tenants in their rental properties. By 2006, SPROLS had built 20,000 units, supplementing those already built by SNIT.

In order to improve the efficiency of supply of urban land for the residential construction that was being undertaken, the Housing Land Agency [AFH] was created in 1973 and given the mandate to supply serviced urban land for development, particularly to low-income households. AFH had powers of expropriation, acquisition and servicing of land before on-selling to developers and eligible households at low cost. In 1980, AFH was recorded as providing 33% of the serviced land needed nationally for housing, which has reduced to less than 10% today, as land has become more difficult to acquire and AFH has ceased using its judicial powers of expropriation¹¹. Despite cross-subsidization measures, AFH's supply of land is overpriced for the poorest households, and not sufficient to respond to the demand of those who can qualify for plots. Applicants are often left on waiting lists for decades, while informal settlements continue to expand.

By far, the largest mode of housing production, particularly of affordable units, has always been self-construction. Of the 70,000 units needed annually in Tunisia due to new household formation and rural-to-urban migration, an estimated 40% is built informally. Of the legal supply, 40,628 units in 2011, at least 80% comes

from individuals, compared to 18% from private developers, and only 2% from public developers. These self-constructed homes are built incrementally, over decades, using concrete, bricks and reinforced steel, and are usually financed over time through household savings and built on un-serviced plots sold by clandestine land sub-dividers via notary title¹².

In response to the existing and growing informal neighborhoods, the National Rehabilitation and Renovation Agency [ARRU] was established in 1981 to coordinate and carry out activities for the renovation and rehabilitation of old quarters and unregulated informal residential areas. Activities include coordinating state agencies for the installation of street lighting, roads, water and wastewater supply networks, and access to electricity. From 1992 until 2012, ARRU has intervened in 950 neighborhoods, and improved the neighborhoods of some 2 million of Tunisia's 10.7 million residents. ARRU's programs continue to remain relevant today, with current work on over 100 neighborhoods in the next 4 year period, using funding from the European Bank for Reconstruction and Development, European Investment Bank, and French Development Agency. This program will address the infrastructure shortfalls in the most needy neighborhoods, yet relies heavily on foreign funds and the state budget, hence is not a cost efficient nor sustainable, means to support the development new urban settlements.¹³

3.3 Current state of housing finance

Tunisia has a developed financial sector in comparison to other countries in the Middle East/ North Africa [MENA] region. Mortgage loans outstanding in Tunisia amount to around 11.8% of GDP. There are three state-owned banks and over 21 private commercial banks, most of which are offering home loan products. Total outstanding housing loans amounted to 12.3 billion TND in 2012¹⁴.

The availability of housing finance is dominated by the national Housing Bank [Banque de l'Habitat], which is 57% publically-owned and accounts for 20.4% of the loans to the real estate sector. The Housing Bank replaced the government-run National Housing and Savings

Fund [CNEL] in 1989, and is a sovereign financial institution, which sells shares to raise funds, and is fully accountable for its performance. Loans offered can be used for house construction or purchase, home improvement and residential land acquisition. Most housing loans are offered following a contractual savings programme, with fixed interest rates of between 5.75 to 6.5%, compared to the interest rate on savings of 4.25%. Direct lending is also allowed, but only with higher interest rates, usually variable, as well as a higher loan-to-value ratio.¹⁵

The Housing Bank also offers construction finance to developers, with interest rates calibrated by the type of housing that will be constructed, whereby social housing is charged at 2.0% above the official cash rate, *taux moyen mensuel du marché monétaire* [TMM], construction loans for market-rate housing is charged at TMM plus 2.5%, and high-income housing is charged at TMM plus 3.5%, where the TMM is fixed monthly by the cost of sovereign bonds from the Central Bank, which was 4.69% as of May, 2013.¹⁶

Mortgage regulations were passed in November 2007. These regulations stipulate that loans will not be given for more than 25 years, and require maturity matching requirements to control asset-liability mismatches. Adjustments of variable rate mortgages are subject to usury law, which limit the rate increase that may be charged, and interest rates on all loans must be fixed after 15 years. This discourages many banks from offering longer-term finance options, particularly when there is not much certainty in the money markets and inflation is increasing. Regulations are shown in the following table:

Mortgage regulations in Tunisia¹⁷

- The loan-to-value ratio is limited to 80%.
- A mortgage loan cannot exceed 25 years.
- Long term loans have liquidity matching requirement: housing loans longer than 10, 15 or 20 years must be funded by resources with maturities of at least 10, 15 and 20 years respectively.
- Interest rate of housing loans longer than 15 years must be fixed.

¹¹ ADEF Etudes Fonciere, Revue Générale des Politiques Foncières Urbaines en Tunisie, 2012.

¹² UN-HABITAT, Tunisia Housing Profile, 2011.

¹³ Agence de la Réhabilitation et de la Rénovation Urbaine: <http://www.arru.nat.tn/>.

¹⁴ Banque Centrale de Tunisie (BCT), Financial Statistics Bulletin. No. 181.

¹⁵ Banque de l'Habitat, The Housing Bank's Annual Report 2011: www.bh.com.tn.

¹⁶ Banque Centrale de Tunisie, Statistiques de la Banque Centrale de Tunisie: www.bct.gov.tn.

¹⁷ Central Bank Instructions No. 87-47, modified in November 2007

Housing finance is a quickly growing sector, with the total value of outstanding property loans to both home-buyers and developers increasing rapidly from US\$1.30 billion in 2003 to US\$7.61 billion as of December 2012¹⁸. Terms vary across institutions, although the average interest rate is around 7.5%, for a variable rate mortgage, the repayment term is 15 years, and the loan to value ratio is 65%.

Progress is promising, yet the high level of non-performing loans [NPL] is still an ongoing issue. NPLs peaked in 2003 at 24.2%, a level that has reduced as the transparency of institutions and loan origination practices improve¹⁹. The Housing Bank had a 13.1% rate of non performing loans in 2011, indicating that there is still work to be done²⁰.

Even though there is substantial development of the housing finance market, in terms of the gross amount distributed as loans, the growing number of mortgages and portfolios of banks is not necessarily indicative of a growth of lending of housing finance down-market, as the key constraints have yet to be addressed.

To facilitate lending to lower-income groups, the Housing Promotion Fund for Salaried Persons [FOPROLOS] was created in 1977. Partly financed through employer contributions, the Housing Bank is the exclusive manager of this state-subsidized housing loan for formally employed low-income households to build or purchase housing. Loan rates for mortgages are below market, and range from 2.5 to 5.75%, for three different income eligibility brackets.

The conditions on FOPROLOS are revised periodically and are shown in the Table 2.

FOPROLOS has been instrumental in making housing finance affordable for low-income workers over the past four decades, however is still limited by some of the pitfalls of formal housing finance. Eligibility for FOPROLOS depends on having a qualifying formal salary, which excludes the 17% who are not registered as employed, and 33% of the educated youth. Furthermore, applicants need to be able to save for the down-payment, between 10-30% of the total purchase price, and banks will not offer credit to those with notary deeds, instead of formal property titles.

Table 2 : FOPROLOS lending conditions²¹

	FOPROLOS 1	FOPROLOS 2	FOPROLOS 3
Income	1x – 2x SMIG*	2x – 3x SMIG*	3x – 4.5x SMIG*
Size	50 m ²	75 m ²	80 - 100 m ²
Total unit cost	32,000 TND	41,000 TND	55,000 TND
Max. LTV	90%	90%	85%
Max. Amount	27,900 TND	36,900 TND	46,750 TND
Interest rate	2.5%	4.0%	5.75%
Term of loan	25 years	25 years	20 years
Grace period	3 years without interest	3 years without interest	1 year without interest
Repayment capacity	40% of gross income	40% of gross income	40% of gross income
Youth Unemployment	33.2%	33.2%	33.2%

* SMIG (salaire minimum interprofessionnel garanti) is the minimum salary, set at 301.81 Tunisian Dinars per month, equivalent US\$186.65.

Source: Banque de l'Habitat, www.bh.com.tn, 2013.

It is estimated that over a third of households still only hold notary deeds, as the process to acquire formal property title takes time and costs money, and the benefits of doing so are not evident to low-income households.

In conclusion, despite all the development and growth in the market, at least 30% of households still do not have any formal access to housing finance at all. This is being exacerbated by the rising price of housing, and loss in purchasing power of Tunisians, where incomes cannot keep up with the rate of increase of consumer goods and other expenditures. This has left most relying on informal financing means, which makes access to formal housing very difficult, and improving living conditions a very long-term process.

4. Contemporary trends in the housing market

Tunisia's achievements over the past five decades have had positive results overall. The average price of housing is much lower than peer countries in the region, for example Tripoli and Algiers where the house price to income ratio is greater than 9, compared to 5 in Tunis. Mortgage penetration and home ownership rates are also higher than North African neighbors.

However, over the past 20 years, housing has become less and less affordable. Housing prices have been steadily increasing since the 1990s at an average rate of 8% per annum²². Prices have increased at a rate higher than inflation and incomes, with little slow down, even during the global financial crisis or recent euro zone slump. Key causes described below include rising demand, ballooning prices of construction materials and land, as well as uncontrolled speculation.

Speculative activity has boomed following the Revolution, as housing is considered the safest and most profitable form of investment, particularly given the prospects of an unstable banking sector and money markets. There are also fiscal and tax incentives that makes putting money in real estate an attractive form of investment. The rapidly increasing number of registered private developers affirms this trend, whereby developers are building simply to store wealth in bricks and mortar; as does the rapidly expanding number of high-rise apartments beside the Marsa highway that runs from central Tunis to the affluent northern suburb of La Marsa.

Key housing inputs such as land and construction materials have also dramatically increased in price in the past two years. The price of land has quickly inflated with the rise in speculation,

¹⁸ BCT, Annual Report, 2011.

¹⁹ World Bank Databank, 2013.

²⁰ Banque de l'Habitat, The Housing Bank's Annual Report 2011: www.bh.com.tn.

²¹ Housing Bank website: www.bh.com.tn

²² ArgusImmo, Le Guide des Prix de l'Immobilier en Tunisia: <http://argusimmo.tn/>, 2012.

rural to urban migration and the popularity of private land banking. There has been tough competition amongst private developers to purchase land at the urban peripheries, who are able to pass on costs to their high-income buyers, while the public sector cannot compete and can no longer resort to the use of eminent domain to acquire land at reasonable prices, due to its political sensitivity.

Construction materials have increased both due to elevated world energy prices and demand pressures from neighboring markets. Tunisia has enough cement production capacity to serve local demand, yet exports (both legal and illegal) have increased to Algeria and Libya, who are both undertaking large-scale housing construction programs, putting pressure on local prices.

New demand has also inflated housing prices. Laws that previously made it difficult for foreigners to own property have been relaxed. Tunisia has the potential to become an attractive alternative to Morocco for Europeans seeking a holiday home. Demand also comes from the large number of Libyans who entered during the Libyan crisis and have stayed. The greatest effect of Libyan immigration has been price increases in the rental market in Tunis.

In the low-income housing sector, there is little interest from private developers, as incentives are insufficient to compete with high profit margins that are being made on for-sale luxury housing. In addition, the rising costs of both land and building materials makes it difficult to build units at prices below the finance ceilings offered through FOPROLOS. Even public real estate developers, for instance SNIT and SPROLS, have been increasing the number of high-income units they build in order to cross-subsidize the losses that arise from selling low-income housing.

The reduction in the supply of formal-sector affordable housing, has prevented an alternative to disadvantaged households, who have no option but incremental self-construction on illegal subdivisions. The political situation has compounded this situation. The loss of rule-of-law has resulted in rapid construction boom of informal and unregulated housing, as building permits and zoning restrictions are no longer

being controlled, and people are making the most of the window to build what had previously been outlawed.

Post-revolutionary Tunisia has become a flurry of activity, both legal and illegal, in housing construction and delivery. Private developers are building as fast as possible, as prices continue to rise, riding the speculative bubble, while low-income households, who have little prospect of being able to afford formal subdivisions and housing, are taking their chance before authority is reinstated, to build informally.

5. Opportunities in housing and housing finance

Given the well-established institutional and legal foundations of housing policy in Tunisia and the rapidly changing regulatory environment of the post-Arab Spring period, there are new opportunities to diversify housing finance options that will increase the accessibility to low-income families and facilitate the formal production of affordable housing. Four particular areas of potential are described below:

5.1. Bank restructuring and development of capital markets

Recently, the International Monetary Fund approved a \$1.74 billion loan for Tunisia, under the conditions that the banking sector is restructured. This opens up the way for new funding mechanisms to be developed for housing finance.

Currently the Ministry of Finance, and Governor of the Central Bank are undertaking an audit of the country's three state-owned banks, in order to reduce the high level of bad debts, insufficient capitalization, and avoidance of regulatory oversight. The Tunisian monetary authorities aim to reach a situation in which the ratio of banks' bad debts does not exceed 7% by 2014.²³

Through this process of bank auditing and extension of the capital markets, funding mechanisms of the banks can be revisited, to overcome the long-term liquidity issues and promote the development of long-term mortgage products.

Types of mechanisms that will be explored include promoting further securitization transactions by local banks. Legislation was put in place in Tunisia in 2001, but the market was slow to develop and it was only first used in 2006 by the Banque Internationale Arabe de Tunisie. Very few transactions have taken place since²⁴. Covered bonds are another long-term funding alternative that are being currently developed in Morocco, which could provide a relevant model for Tunisia to follow.

5.2. Facilitating private banks to lend down-market

Further measures can be taken to facilitate existing banking institutions to lend to lower-income groups. The subsidized finance provided through FOPROLOS will need to be reformulated so that it matches the rising costs of housing, and so that the subsidies that are provided through the FOPROLOS fund are available to be offered by a wider set of qualified commercial banks. This will level the playing field by extending the program and benefits beyond the national Housing Bank, which is currently the sole provider of FOPROLOS.

Meanwhile, guarantee programs, similar to the Guarantee Fund for those with Irregular and Modest Incomes [FOGARIM] in Morocco, which provides commercial banks with a 70-80% guarantee if loans are given to households that would not normally qualify. A partial government guarantee can provide incentive to banks to develop more flexible and innovative housing finance products suit those who may not have formal salaries, or land titles, yet whose loans can be underwritten using other standardized techniques.

5.3. Supporting growth of housing microfinance for home improvement

Housing microfinance is a financial product that well matches the primary mode of housing production for low-income families. Housing microfinance supports incremental housing construction, with lower loan amounts, shorter repayment terms, and is better suited for alternative land tenure situations, such as notary title.

²³ Kammoun, N, and A. Ammar, The Evolution of Competition in Banking in a Transition Economy: An Empirical analysis of the Tunisian Banking Sector, International Journal of Business and Social Science, Vol. 3 No. 13; July 2012.

²⁴ Gide Loyrette Nouel, Northern African Countries Open Up To The Possibilities Of Securitization, The Global Securitization Guide, 2006.

In Tunisia, there is new scope for growth of a housing microfinance sector as a legal change is opening the industry to new microfinance market entrants. The Microfinance Law from 1999 was revised in November 2011 to lift the interest rate cap (of 5% per annum), which has previously made it financially infeasible for microfinance institutions to operate in Tunisia. Enda Inter-Arabe is the only exception, as it was classified as an international non-government organization [NGO] when it started operations in 1994, and managed to avoid the interest rate cap to become a virtual monopoly. Now, there are many foreign MFIs that are planning launch in Tunisia as soon as licenses become available through a new licensing authority. Furthermore, the EU is offering grant funding to support the start-up and scaling-up period of three microfinance entrants.

As the microfinance industry grows in the country, the feasibility for housing microfinance as a financial product also grows. A housing microfinance product already exists. In 2008, ENDA-InterArabe, launched a new product called "Eddar" specifically for housing improvements. Home-improvement loans are offered from US\$600 to US\$3000, usually over a period of 12 - 18 months, but up to 36 months. At the end of 2009, the Eddar loan made up 6% of their total loan portfolio, with 3452 active clients, \$2 million outstanding, average loans were for \$900 and 15 months duration²⁵. This has increased to over 12% of the total loan portfolio in 2013. The demand for this product is great and further growth is limited by strategic priorities of ENDA.

An extensive 2011 report on the microfinance sector in Tunisia by the European Union concluded the additional demand to be substantial, estimated at between 700,000 to 1,000,000 Tunisians as potential untapped customers of microfinance, while CGAP reported 1.2 to 1.4 million²⁶. This estimation, based on the number of households excluded from formal bank credit, is also indicative of the prospective demand for home improvement microfinance.

5.4. The development of Islamic housing finance

Another new development in Tunisia is the emergency of Islamic housing finance products. Although lease-to-own housing has long existed on a small scale via expensive leasing companies, only two private financial institutions currently advertise Sharia-compliant housing finance. The first product, using *mourabaha*²⁷, was offered by Zitouna Bank in 2009²⁸. It is likely that more banks will investigate offering Islamic-compliant housing finance in Tunisia to respond to the new demand that has come with the removal of restrictions on religious expression in Tunisia, along with increased investment interest from the Gulf countries.

The government has also set up a regulatory council to explore the financial-sector implications of the introduction of Islamic finance. Tunisia has already started discussions around offering a sovereign *sukuk*²⁹ with an issuance likely in 2014, yet political tensions over the draft constitution, among other priorities, have kept Tunisia's parliament from debating any legislation that would allow the government to apply Islamic finance instruments. Meanwhile, Egypt is proceeding with a *sukuk* issuance, with a law specified in May 2013, which could set a precedent for Tunisia for the diversification of funding instruments for the banking sector, and consequently, for housing finance.

6. Conclusion

As this article outlines, access to quality housing is one of the top concerns in post-revolutionary Tunisia, as it has become in many countries in the MENA region. Housing is linked to the concept of dignity and is a key aspect in facilitating social stability and people's inclusion in the democratic process. Tunisia worked hard directly following their independence to create an environment that would allow average households to access decent homes, both in terms of affordable housing

finance as well as the supply of low-cost housing, yet failures in this system over the past decade resulted in revolution.

In Tunisia, housing continues to become increasingly inaccessible, and households have no alternative apart from building in informal subdivisions on urban peripheries. As Tunisians become more educated, and face challenges to find employment or a living wage to support their families, this reality has become unacceptable.

There is now political will to revise the path of housing policy, to transform the uncertainty of revolution into an opportunity for positive interventions. These opportunities, on the side of housing finance, for product diversification and market-deepening, have been briefly outlined; yet exist equally on the side of housing delivery.

Through a process of careful review and reform, Tunisian policy-makers can use effective housing policy as a tool, not only to respond to the basic needs of the population, but also to address the national priorities. Increasing employment, reducing regional disparities, and sustained economic growth will point Tunisia toward the prosperous and inclusive future that its citizens are fighting for. However, agreement on the new constitution, free elections, as well as political and financial stability must be achieved in parallel, which still does pose a grand challenge.

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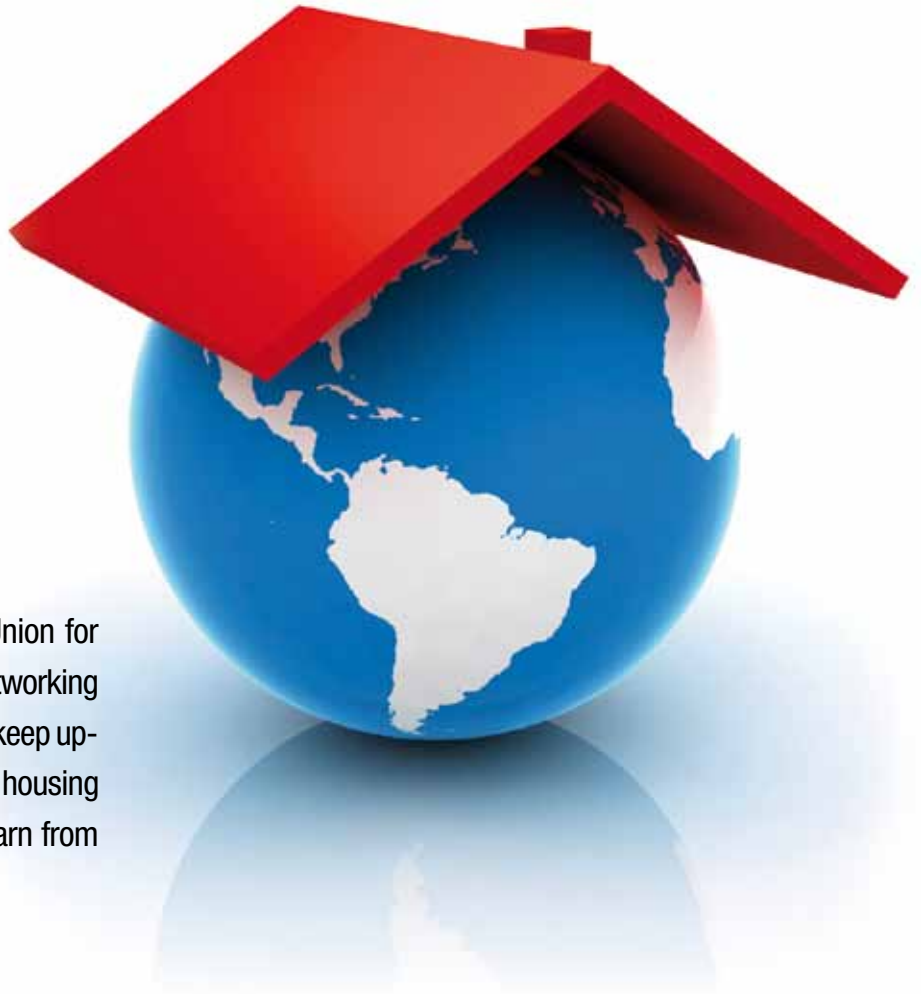
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²⁷ Murabaha is a sales contract at cost plus a known and agreed between the bank and the customer margin. Zitouna Bank purchases the good chosen by the customer and resells it for an installment payment on an agreed period between the two parties.

²⁸ Banque Zitouna, www.banquezitouna.com.

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International Union for Housing Finance | Rue Jacques de Lalaing 28, B 1040-Brussels - Belgium | Tel: +32 2 231 03 71 | Fax: +32 2 230 82 45