

# HOUSING FINANCE INTERNATIONAL

The Quarterly Journal of the International Union for Housing Finance



- ➔ **Housing purchases by foreigners in France**
- ➔ **The effectiveness of the French credit system faced with the challenge of budgetary restrictions**
- ➔ **BASEL III to deliver a further blow to “financial inclusion” for South African mortgagors**
- ➔ **Towards cost effective private financing of affordable rental housing**
- ➔ **Sustainable housing finance – an approach to get housing finance back on track**
- ➔ **Investment in housing: demand versus supply side subsidies – conclusion of the debate**



# International Union for Housing Finance

## Housing Finance International

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E-mail: [hamm@housingfinance.org](mailto:hamm@housingfinance.org)

#### → Head of Department of Economic Affairs:

Mark Weinrich,  
E-mail: [weinrich@housingfinance.org](mailto:weinrich@housingfinance.org)

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For further details, please contact Anja Gruhn  
([gruhn@housingfinance.org](mailto: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](http://www.housingfinance.org)

Secretary General: Hartwig Hamm

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# International capital; meeting local housing needs?

↳ By Andrew Heywood

It is still relatively unusual in practice to speak of international housing markets. Although we all accept that national and regional housing markets are interconnected to varying extents, analysis of such markets still, by and large, treats such markets as driven by forces within their own borders.

There are exceptions at the very local level, where commuting patterns and similar factors may add additional dimensions to the picture. Certain sub-regions within national markets may be influenced by particular phenomena such as second homes in Scotland and in rural areas of France. In the latter case there is clearly an international dimension, with buyers from the United Kingdom and other states maintaining significant levels of inward investment.

Capital cities have always been recognised as having some international dimension. London has been no exception. The city as a whole has sustained higher house prices than the UK as a whole, and it has been accepted that foreign buyers have played a part in this, particularly in the more desirable boroughs such as Kensington, Chelsea, and Westminster.

However, since 2007, overseas investment in residential property in London has expanded dramatically. In 2009 such investment amounted to £2.4 billion. In 2010 this grew to 3.7 billion. In 2011 the figure had expanded by 40% to £5.2 billion. It is still growing; 2012 is expected to be a record year.

The figure of £5.2 billion is equivalent to around 32% of all mortgage lending for house purchase in London in 2011. It is more than 50% of all planned government spending on the 2012 Olympic Games. It represents more than the entire government budget for affordable housing in England for the period 2011-15.

It has been estimated that overseas buyers were responsible for around 60% of all new-build sales in central London in 2011. Their influence on the overall supply of housing in the capital and on prices cannot be overestimated. Average prices in England fell 3.5% between 2007 and 2011. In London they increased by

3%. In Kensington and Chelsea they rose by over 20%, bringing the average price in the borough to £1.25 million. This represents a staggering price to income ratio of 27.07 for a household in the borough on the median income. Overall home ownership levels in London could be down to around 40% by 2025 on current trends.

The situation in London prompts a range of questions about how international investment flows can be reconciled with the need to make housing affordable for the majority of those who live and work in the City. It also raises questions about the extent to which the London experience is replicated in other cities on the international circuit and about what lessons can be learned.

There is a real case for a comparative study of major cities in terms of the international influence on their housing markets and the implications for meeting local housing need. If anyone plans to embark on such a study or is keen to fund one do let us know.

Inward investment is the subject of an article by Claude Taffin who examines the sources and impact of inward investment by non-resident foreigners in France. He analyses the departments of France that have been most affected, the distribution of the different nationalities involved, and the behaviour of these purchasers since the onset of the banking crisis in 2007.

France is also the subject of an important article by Bernard Vorms in this edition of HFI. Mr Vorms analyses the French system of housing finance and charts the degree to which it has been resilient in the period since 2007. His article raises important questions about whether the system will prove as resilient in the face of recently announced government spending cuts, and whether housing expenditure in France will continue to play its traditional counter-cyclical role.

With national housing budgets constrained worldwide and with financial turmoil continuing in the Eurozone, the funding of affordable housing is a very real problem in many countries. In a timely article Julie Lawson and colleagues examine the

possible role of Housing Supply Bonds in providing a means to attract private investment to the Australian not-for-profit sector. The proposal is currently attracting political interest in Australia and is being considered by the Government.

From South Africa Pierre Venter discusses the likely effects of the implementation of Basel III requirements in South African banks. He argues that the outcomes could be a reduction in availability of funds and an increase in interest rates. This could in turn lead to a drop in economic activity and an erosion of current levels of financial inclusion in terms of housing finance.

Originating in the ecology movement, the term “sustainability” has seen its meaning extended to include an economic, fiscal and social dimension. In a fascinating article Mark Weinrich and Juri Schudrowitz examine the various approaches to the funding of secured housing finance via deposits, the different ways of gaining access to the capital markets and contractual savings schemes. They go on to comment on the degree to which these approaches can be considered to be sustainable in the various senses of that term.

Our debate on supply-side versus demand-side subsidies for housing in the spring issue of HFI proved lively, raising as many issues as it answered. The debate concludes in this issue with two new contributors. Rob Van Hoofstat emphasises the importance of demand subsidies while Rudy de Jong shows the advantages of intervening on the supply-side. However, both contributors recognise that some combination of the two can frequently have advantages.

In addition to the articles described above, HFI also includes regional news columns on Europe, the USA, South America, Africa and the Asia Pacific region. Introduced for the first time in the spring edition, these features focus on recent market and policy developments, together with news on important events such as conferences and international forums. We hope that you will find these columns to be a useful way of keeping well-informed about what is going on across the globe.

# Contributors' biographies

**Rudy de Jong** (1953) is graduate anthropologist and master of real estate. He is working in the Dutch Social Housing sector since 1981 and was board member of national and international organisations including the Dutch national federation Aedes, the European federation Cecodhas Housing Europe and a Dutch and Armenian Housing Association. Rudy de Jong published several articles on social housing and housing market regulation. Email: rudydejong55@gmail.com

Senior Research Associate **Dr Julie Lawson** is a housing researcher and urban planner with the AHURI/RMIT Research Centre, Australia, and has played a leading role in research concerning social housing finance, with eye opening international field work on innovative developments in policy, evaluations of their robustness during the financial crises and critical assessments of their relevance to Australian conditions. Corresponding author: Julie.lawson@rmit.edu.au

Associate Professor **Dr Vivienne Milligan** is a geographer with the City Futures Research Centre, University of NSW. Vivienne has exceptional knowledge of the capacity of the social housing sector in Australia through her extensive policy, research and senior management experience, spanning over 30 years.

**Alex J. Pollock** is a Resident Fellow at the American Enterprise Institute, a Washington, DC think tank. He is a Past-President of the IUHF, and was President and CEO of the Federal Home Loan Bank of Chicago 1991-2004. He can be contacted 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. Email: kecia@iafrica.com

**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 Adviser to the Inter-American Housing Union (UNIAPRAVI). Email: atecnico@uniapravi.org

**Juri Schudrowitz** is an economist with the Association of Private German Bausparkassen. His areas of activity include real estate market analysis, systems of housing finance and sustainability of housing. He holds a degree in economics and graduated from Bayreuth University, Germany, with a doctoral thesis on institutions and public expenditure. His previous employers were the BDI - Federation of German Industry (economic department) and the German Federal Ministry of Finance (European policy). Email: schudrowitz@vdpb.de

**Claude Taffin** is currently the scientific director of DINAMIC, an entity recently created by the French notaries to operate their real estate databases. He previously worked for the World Bank as a senior housing finance specialist. Earlier, he headed the Housing Department of the French Bureau of Statistics (INSEE) before joining Credit Foncier, a mortgage lender, and Union Sociale pour l'Habitat, the union of social rental organizations (Hlm) as chief economist. He holds degrees from Ecole Polytechnique and Ecole Nationale de la Statistique et de l'Administration Economique (Paris). Email: ctaffin1@yahoo.fr / claude.taffin.csn@notaires.fr

**Rob Van Hoofstat** is a Master in Civil Engineering and alumnus of the Vlerick Leuven-Gent Management School. He is co-author of the book "Pénurie d'habitat", about the challenges and solutions for the Belgian housing sector. He contributes to the Itinera Institute, an independent Think Tank, and is also a member of the strategic Housing Council of the Flemish Region." Email: robert.van.hoofstat@telenet.be

**Pierre Venter** is a housing specialist who has over 25 years' experience in housing within the banking environment. He holds a Bachelor of Commerce degree, a Master of Science Degree in Housing (Building), a banking diploma, a mini MBA together with a number of property diplomas. Pierre is employed by The Banking Association South Africa as General Manager, Banking and Financial Services Division, which includes oversight for the various property, physical infrastructure and sustainable finance committees. Email: pierrev@banking.org.za

**Bernard Vorms** is director of ANIL (National housing information board) and President of the SGFGAS/guarantee fund for social home ownership. He is chief editor of the review "Habitat-Actualité". Bernard Vorms has been entrusted by the European Commission and by the French Government with several reports on the housing market, home ownership and housing finance. He is graduated from Institut d'Etudes Politiques de Paris and holds an Advanced Studies Degree in Economics from Paris University. Email: Bernard.vorms@gmail.com

**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 and he is heading the Department of Economic Affairs for the International Union for Housing Finance in Brussels. Email: weinrich@vdpb.de

Associate Professor **Dr Judith Yates**, School of Economics, the University of Sydney, and member of the National Housing Supply Council is one of Australia's leading housing economists. She has an extensive publication record covering housing finance issues, ranging from shared equity arrangements, taxation issues to equity bonds.



# Housing finance news from Africa: Innovation to tackle affordability

↳ By Kecia Rust, African Union for Housing Finance

Innovation and progress in housing finance in Africa was centre-stage at three conferences in recent months. In late March, Oxford University's Centre for Studies in African Economies (CSAE) held a meeting to explore "urban mass housing" in Africa. This was followed in May, by the World Bank's 5th Conference on Housing Finance in Emerging Economies, in Washington DC. Then, at the beginning of June, Shelter Afrique held its 31st Annual General Meeting and Symposium, this year in Kigali, Rwanda. All three events sought to bring together practitioners – lenders, developers, investors, academics, NGOs and others – to discuss the challenges and opportunities in housing in Africa. What was perhaps most striking about these three conferences was the extent to which each offered illustrations of real potential. As the investor community explores opportunities for work in Africa, housing has become a point of interest for many.

At the Oxford meeting, Dr Marja Hoek-Smit, Director of the International Housing Finance Programme at the Wharton School's Zell/Lurie Real Estate Centre, gave an excellent presentation on "scaling up housing finance in Africa". The presentation provides examples of innovation and financial deepening in different areas of housing finance – development and construction finance, finance for rental housing, mortgage finance, and non-collateralised credit or housing micro finance. Hoek-Smit notes the growing importance of private equity in Africa at all levels. Fundraising by Private Equity Funds for Sub-Saharan Africa reached \$41.5 billion in 2010, comprising 6% of all fundraising for emerging markets. While emerging Asia and Latin America and the Caribbean still dominate as investment targets, Sub-Saharan Africa's share of the market has grown significantly since 2007 and looks set to grow even further. Equity investors such as International Housing Solutions and Actis are targeting middle-income rental and mixed developments. Shelter Afrique, a Pan African financial institution that offers housing finance and other services to developers and housing finance institutions in its member countries, has just established the Pan African Housing Fund, a real estate private equity fund with a targeted close of \$40 million by the end

of Q2 2012. There are joint ventures such as the Renaissance Group's Tatu City that are promoting scale developments, and social impact and other development funds, such as Acumen, CLIFF (Community Led Infrastructure Finance Facility), and the New Urban Finance Facility for Africa are working with microfinance organisations and infrastructure providers on initiatives that offer important demonstration effects.

A key challenge raised by Hoek-Smit with respect to the mortgage finance arena has to do with the risks (and costs) of lending to middle and lower income groups. To this, a presentation given by Mr Nouaman Al Aissami, of the Ministry of the Economy and Finance in Morocco, at the World Bank's conference in May offers some useful insights. Al Aissami describes Fogarim, a guarantee scheme developed to encourage banks to finance low and irregular (informal) income households. A precondition of the scheme is that the borrower is a first time homeowner whose income is informal. The monthly loan payment should be less than about \$176 (1500 Dirham). The guarantee covers 70% of the loan which must have a fixed interest rate. Guarantee commitments are limited to 8 times the fund's equity and the borrower must have life insurance, and the house itself must be secured with a mortgage. The premium for the guarantee is correlated with LTV: the annual premium of 0.325% for LTVs less than or equal to 50% and higher thereafter. To date, Fogarim has served about 80 000 borrowers, with about 1200 new borrowers coming on stream each month. The total value of outstanding guarantees is reported as \$1.3 billion (11 billion Dirham). Of course, Fogarim is just one instrument within a wider suite offered by the government to enhance access to housing finance in Morocco. With a housing shortage estimated at about 500 000 units and a growth rate of 150,000 new households per annum, the government has been under pressure to ensure a comprehensive mortgage finance system that meets the needs of as many Moroccans as possible.

An initiative in Kenya, presented at the Shelter Afrique Symposium in June, illustrates a different approach to enhancing access to housing

finance and affordable housing. Mr Wagane Diouf of Urbanis Africa Limited presented a project being developed by Jamii Bora, known as New Kaputei Town. By centralizing and integrating all the components of the housing delivery chain, from land purchase to infrastructure investment, construction and development financing, housing construction and end user financing, to the long term property management of the settlement, and by undertaking most of this internally, Jamii Bora has been able to contain costs and provide an exceptionally affordable product. Community based construction methodologies as well as the in-house production of key building materials – concrete blocks and roof tiles – also keep the costs down while offering residents income-earning opportunities. In the longer term, Jamii Bora Makao organizes the delivery of property management services, managing common property and providing basic services such as refuse removal, security and water treatment facility management. For this, residents pay a fee of \$12 per property per month.

The project benefits substantially from grant funding and patient impact investors interested in the social return. Working capital has been funded from a combination of equity and debt from Jamii Bora Scandinavia, a fund established in Scandinavia to support the Jamii Bora effort, and all funding is transparently documented so that over time, Jamii Bora can move to a commercially viable model. In the short term the project makes provision for a target margin of 30% to remunerate capital, fund interest payments and maintain the intended level of long-term investments. As a result, a two-bedroom house at Kaputei costs \$14,005, with materials, labour, infrastructure, power, professional fees and land totaling \$10,570, and the remaining 32.5% covering finance charges.

New Kaputei Town is not a massive project – to date, 551 houses have been built of which 246 have been sold. When it is complete, it will accommodate 2,000 families on 293 acres of land about 60km outside of Nairobi. The project plans to be fully 'green', developed within an ecologically sound and sustainable framework.

If it works, and if its investors remain satisfied in their returns, it stands to offer very useful lessons for the development of affordable housing for very low income earners. By 2015, Jamii Bora Makao intends to build at least 10,000 affordable houses matched with financing solutions that match its members' ability to repay.

Another innovative example worth mentioning is the Lagos Chois project, presented by Shelter Afrique's Femi Adewole at the Symposium in Kigali. This is a public private partnership which seeks to deliver up to 30,000 new, affordable homes by 2015, in sustainability communities. The project delivers an affordable housing financing arrangement, involving the promotion of housing savings clubs and shared equity purchase schemes as an alternative to the traditional mortgage scheme. At least 40% of homes will be sold to low income earners at a maximum price of \$20,000; the remainder will be sold by the developer at a market rate. Similar to Jamii Bora, the project also offers construction apprenticeship opportunities for up to 2,500 trainees and is promoting innovation and best practice in sustainable design, including energy efficiency and recycling.

A key challenge in developing housing finance opportunities in Africa is the ability to engage with the nuance of affordability – both in terms of how much people earn and the manner in which they earn it. Innovative initiatives seeking to address this challenge are now clearly operating, and realizing successes that bear reporting, in a number of African countries.

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# Asia Pacific region

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

The World Bank held its 5<sup>th</sup> Global Housing Conference in Washington on May 30-31, 2012 on the theme "Housing Finance in Emerging Markets". Mr. Zaigham Rizvi Secretary General APUHF presented a briefing on APUHF in the Session "Housing Finance Projects-Speed Dating". The Conference was attended by more than 200 delegates from around the globe. The papers presented at the World Bank Housing Conference will soon be available on the World Bank Website. The Secretary General APUHF also attended the Annual Meeting of the Association of Development Finance Institutions of Asia-Pacific (ADFIAP) held in Istanbul, Turkey and presented a paper on housing challenges in Asia-Pacific and the role of the APUHF.

The Governor of the Central Bank of Afghanistan HE Noorullah Delawari is paying special atten-

tion to the development of institutional and regulatory structures for housing finance in Afghanistan. He has approached the APUHF for possible technical assistance in the areas of Prudential Regulation, Mortgage Guidelines, a housing finance business model, and Sharia-compatible housing finance. Mr. R.V.Verma, Chairman APUHF and MD of National Housing Bank India has assured the Afghan Bank of all possible support.

In Pakistan the State Bank (Central Bank) has decided to have housing finance prudential regulation separated from consumer finance prudential regulation and is currently in the process of finalising this. In India the National Housing Bank is playing a key role in the promotion of green housing projects, with technical assistance from international agen-

cies like KFW. In Bangladesh, the Managing Director of Bangladesh House Building Finance Corporation-BHBFC, Dr. Nurul Alam Talukder has taken many initiatives to expand the role of BHBFC in pro-poor housing supply and finance. For this purpose, while in Washington attending the World Bank Housing Conference, he had meetings with World Bank officials. BHBFC also intends to hold a regional housing conference in Dhaka to learn from pro-poor housing initiatives in different countries of the Asia-Pacific region.

While in Washington attending the World Bank Conference, Mr. Zaigham Rizvi of the APUHF and Ms. Kecia Rust of the Centre for Affordable Housing Finance in Africa held meetings and decided that both these institutions will cooperate with each other in promoting the cause of affordable housing.



# Europe: a shifting regulatory landscape

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

When talking about Europe's real estate market, it is important to note that there is not one single European experience of housing market development. There are both common experiences and very divergent ones. However, claims about a convergence of the performance of Europe's housing markets have been proven wrong – the years since the beginning of the crisis have thoroughly disproved this shaky thesis. Substantial country differences prevail.

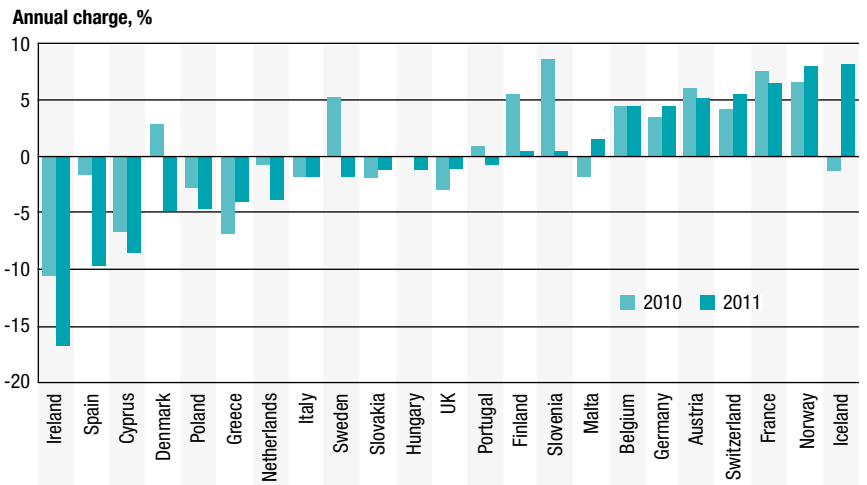
A common experience of European housing markets was that by the end of year 2008 prices were either stagnant or down in all countries. However, the recovery from this slump exhibits considerable variation. Figure 1 shows that house price changes in 2011 were broadly similar to those of 2010, reinforcing a pattern of geographic bunching of market outcomes, amidst all the diversity. The larger group is troubled with broadly flat or declining house prices, while some countries show a clear upward trend.

The latter is, for example, the case in most Nordic countries, which initially registered sharp price falls followed by decent price rises since 2009. France's housing market profits from stimulus measures by the government and in Belgium a fast economic recovery, helped by low interest rates, caused house prices to rise. Austria, Germany and Switzerland also reported a rise in prices, but these markets – especially Germany – are anyway characterised by very stable real estate markets. Central for this year-long stability is a housing finance system based on a prudent financing culture (including a system for down-payment savings) and a stable funding base.

In contrast, Cyprus, Ireland and Spain have experienced declines in house prices for four consecutive years. Greece and most Middle and Central European countries have been struck by housing market corrections. Their real estate markets overheated in the boom years; low credit requirements and lax underwriting standards were the rule.

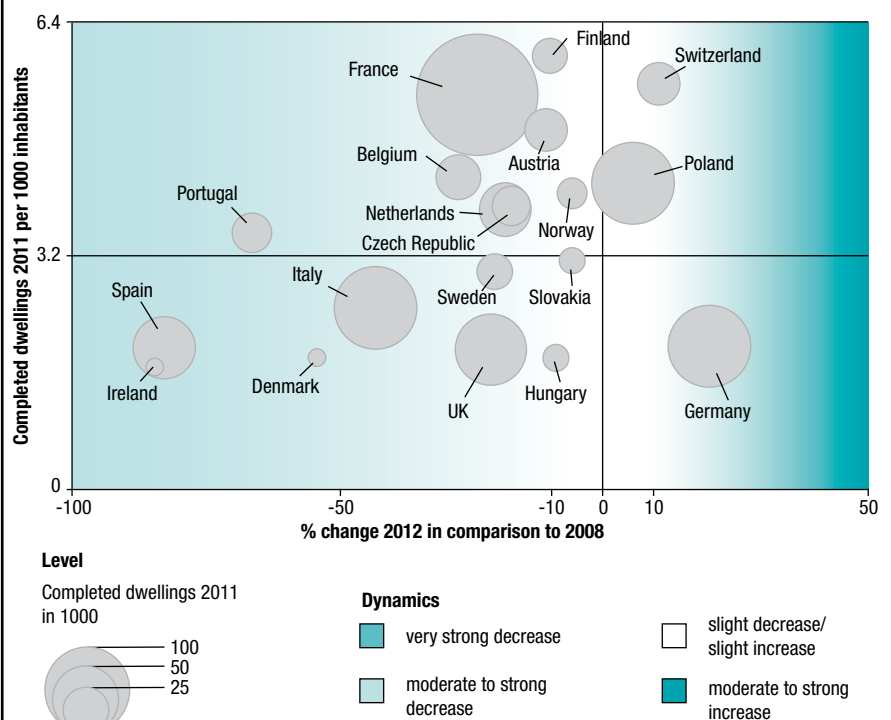
Figure 2 elucidates that the volume of new housing construction in most European countries is still far behind the level of 2008. Only Germany, Poland and Switzerland show a positive trend. But if the completion rate per capita is taken into

**Figure 1 House price changes 2010 and 2011**



Source: RICS, European Housing Review 2012, p. 7.

**Figure 2 Completed dwellings in Europe – level 2011 and dynamics 2008 in comparison to 2012**



Source: Euroconstruct, Summary Reports 2011; Bundesinstitut für Bau-, Stadt- und Raumforschung, Wohnungs- und Immobilienmärkte in Deutschland 2011.

consideration, Germany is on the bottom of the table together with Denmark, Hungary, Ireland, Spain and UK. And in spite of the positive dynamics it is very likely that housing completions per capita in Germany will, in the medium term, remain below the European average. However, investment in construction as a share of GDP has also been remarkably stable over the years in Germany and is, at around 10%, comparable to the levels of other big European economies.

The divergent development of national real estate markets across Europe confirms that the housing finance industry is faced with different challenges from country to country. The interests will therefore be different – not only from country to country but also from lender to lender.

However, CRD IV – which will transpose Basel III into European regulation – and, to a lesser extent, Solvency II – the “Basel for insurers” are important issues for everyone in the industry.

In light of the new capital requirements of Solvency II, it is very likely that mortgages will become a more interesting asset class for insurance companies. While commercial real estate might be of major interest for the insurers it is becoming also more interesting to deal with a business area which has played so far a stra-

tegically minor role in this sector; mortgage lending to private customers. It is not only the favourable treatment of residential mortgages under the new rules that will shift the investment behavior of insurers but also the low-yields of government securities that necessitate investment alternatives.

Basel III is – of course – a much bigger issue, and despite the divergent interests in the housing finance industry there seems to be at least one common interest regarding the new regulations: flexibility!

The members of the European Parliament apparently share this view. The relevant Committee of the Parliament and the European Council adopted their preliminary positions on 14 and 15 May, respectively, and have now entered negotiations to find a common compromise text. However, it is very likely that the negotiations will be difficult. The European Parliament does not only want more ambitious rules than the Council but also more flexibility under the new rules which would grant member states considerable discretion. In principle, the Council favours a position of maximum harmonisation of the proposed rules.

Of special interest for housing financiers is the position of the European Parliament on

rules concerning Loss Given Default and the Leverage Ratio. While the Council wants to establish a uniform minimum floor of 10% for the Loss Given Default for residential property, the European Parliament wants to leave it to the discretion of national supervisory authorities to set (if necessary) a minimum Loss Given Default floor. The leverage ratio is another field of dispute. Both Parliament and Council want to oblige the European Banking Authority to write a report by 31 October 2016 on the impact and the efficiency of the leverage ratio. However, the Members of the European Parliament believe that credit institutions can be classified according to business models and risks into three groups. A distinctive leverage ratio (5%, 3% and 1.5%) would be assigned to each group. In this context, the financing of residential property shall be, *inter alia*, considered as a low risk business model.

These two examples suggest that the Parliament's striving for more flexibility might help to make the new regulatory rules more acceptable for European housing financiers. There is hope that both Parliament and Council understand that more flexibility accommodates the different national circumstances better than strict harmonisation – better not only for housing finance but also for overall financial stability.

# North America – living in the political wake of the U.S. housing bubble

↳ By Alex J. Pollock, Resident Fellow at the American Enterprise Institute

The U.S. is living in the wake of the great 21<sup>st</sup> century bubble and its collapse, as a dominating influence in the financial, economic, and political spheres.

The financial consequences reflect the huge overhang (and hangover) of excess debt. The financial bubble included a vast creation of debt based on asset prices that no longer exist, particularly in the housing market. After the collapse, there was a \$7 trillion correction in price (or a 30% correction)—this took U.S. average house prices back to their long-term trend-line. If we continue along the trend-line, we will reach the 2006 peak prices again in 2020.

While the asset prices have adjusted back to their long-term trend-line, debt has only partially adjusted. Here is Pollock's Law of Finance: when debt can't be paid, it will default. Additionally, the collapse of the housing market has turned the Federal Reserve into the largest savings and loan institution in the world, owning nearly \$1 trillion in mortgages, all funded short. The Fed, as Manager of the Banking Club, is also depressing short-term interest rates so banks can gradually work their way through their loan losses.

The bust slowed economic activity overall, of course. It has now resulted in a bi-modal credit market: bond markets are booming, but the banking system is clogged, reflecting procyclical banking and regulatory behavior.

The political aftermath of the bubble is a wholly predictable repeat of history. Following a crisis, there is always a political phase. The political phase involves first finding a way to assign blame and opprobrium, and then to "Do Something." After the financial bust in the 1980's, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act in 1989, the FDIC Improvement Act in 1991, and the Safety and Soundness Act in 1992. After this, the Secretary of the Treasury said "never again" would a financial crisis happen - a poor prediction.

The Dodd Frank Act is the latest "Do Something" event—an act that is reorganizing and greatly expanding the regulatory jurisdiction throughout the financial sector. At the top of this regulatory expansion is the "Financial Stability Oversight Council" (FSOC) established by the Dodd-Frank Act—a cumbersome, very political super-committee whose efforts will be spent mainly protecting turf and jurisdiction among its component regulatory bureaucracies.

One of the biggest causes of the bubble and financial crisis was the government itself. How will this highly political body be able to criticize the government? Let us recall the excellent question posed to Federal Reserve Chairman Bernanke by Senator Bunning: "How can you regulate systemic risk when you *are* the systemic risk?" On the whole, the real role of the committee may end up being just for show, to prove that the government is Doing Something, without doing much.

Moreover, the FSOC is unlikely to succeed at correctly forecasting and preventing crises. There is no evidence that regulatory bureaucracies can generate the superior knowledge of the future required to do so. Regulators make the same cognitive mistakes as everyone else. They participate with private financial actors in "cognitive herding," where everyone's view reflects the same ideas.

The financial sector displays fundamental uncertainty: recursively interacting expectations and behavior cannot be accurately calculated. The recursiveness of financial markets means that everything you anticipate and do changes the market-- what you believe about the risk distribution changes the risk distribution. A regulatory super-committee cannot change this profound reality.

Although financial cycles cannot be eliminated, here are four suggestions to moderate future cycles:

First, develop counter-cyclical loan-to-value (LTV) ratios. The LTV ratio indicates how much one is willing to lend against the current market value of the asset. Typically, the LTVs in housing finance tend to go up as house prices rise, but they should go down when the prices go up rapidly. This will help dampen the cycle. Canada has actually implemented something along these lines, where they have reduced some maximum LTV ratios in reaction to their booming house prices.

Second, the practices regarding loan loss reserves should require that bigger loan losses be built during the good times. When optimistic loans are being made, we should be building up loss reserves, because loans made during a boom are certain to be the biggest losers later.

Third, the government should encourage the creation of new banks during the bust. Now, the bond market is booming but the banking market is restricted. New, little banks are needed to work with small businesses and entrepreneurs. Now is the best time to enter the banking business because credit is conservative. U.S. regulators tend to charter new banks in the boom and close off the creation of banks in the bust, mainly because then FDIC needs the capital for failed banks and doesn't want to allow it to form new competitive banks instead. This is precisely the wrong policy, and should be reversed to help resume growth following a crisis.

Finally, saving, not just lending, should be encouraged as an essential element in housing finance.

These are things we should be working on in the political wake of the bubble.

# The Quality of housing loans in Latin America

➔ By Ronald A. Sanchez

## 1. Expansion of housing credit

The strong growth in housing credit is due to the joint action of public and private players. The ratio of mortgage balances to GDP is an indicator that measures the depth of the mortgage markets in our countries, and the highest ratios are Panama with 22%, Chile 18%, Costa Rica 17%, El Salvador 13% and Mexico 10%. The other countries analyzed have a ratio of less than 5%, including Brazil, Colombia, Peru and the Dominican Republic who have had strong growth in housing loans in recent years but still have much room to grow.

## 2. Reducing interest rates

In Latin America, there is a clear downward trend in interest rates on mortgage loans, because there is increased competition from players in housing finance. In 2003 the average rates in the region were about 17%, however in 2011 they reduced

to 10%. Costa Rica presents a significant reduction in interest rates, from about 30% in 2003 to 13% in 2011. El Salvador, Panama and Chile show lower and stable interest rates of around 8%, 7% and 5% respectively. The other countries had reductions of between 3 and 6 percentage points.

## 3. Reducing index of default on housing loans

In the last century many public housing financial institutions were created in Latin America dedicated to granting housing loans and to direct construction. Due to different political and economic conditions, and in several cases, poor governance, many of these entities have been eliminated or absorbed, and some institutions have become more autonomous, modern and efficient. On the other hand there were private entities specializing in housing finance such

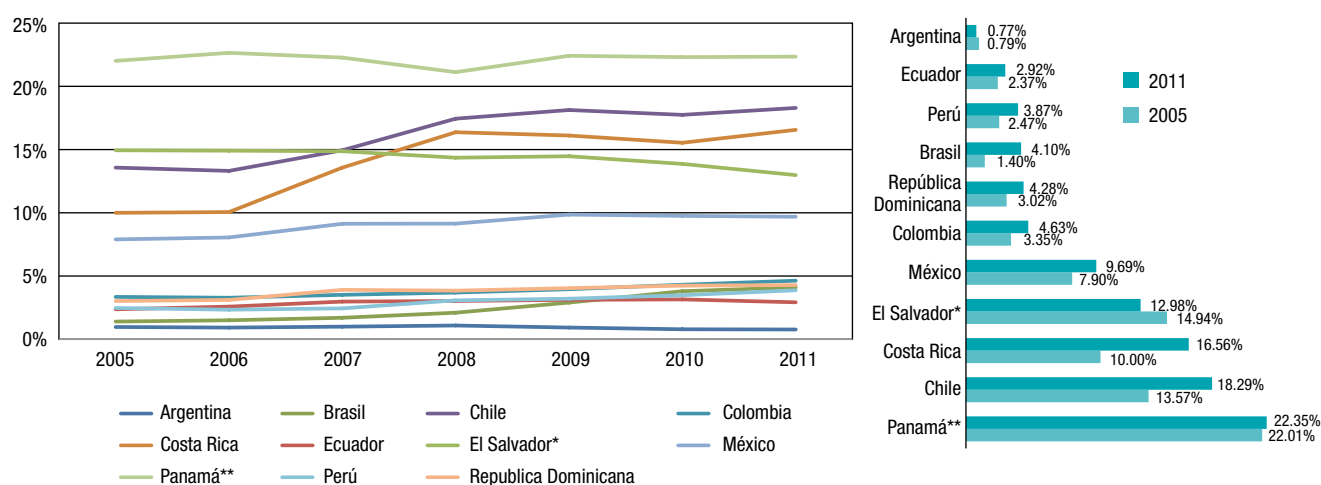
as mutuals, savings banks, cooperatives and the savings and credit associations, who were becoming mainstream players in dealing with housing shortages with support of funds and public banks.

Latin America was hit by an inflationary crisis in the 80s and by globalization. High interest rates and levels of mortgage default led to the reorganization of housing policy, reforms to housing finance systems, improved monitoring, adaptation to the principles of Basel, and redirection of public institutions into a facilitator role.

## 4. The case of Colombia

In the late 90s, Colombia lived through a severe mortgage crisis, with high levels of default. The reforms were aimed at further regulation, reformulation of indexing, allowing the granting of mortgage lending in local cur-

Balance of housing credits / GDP 2005-2011

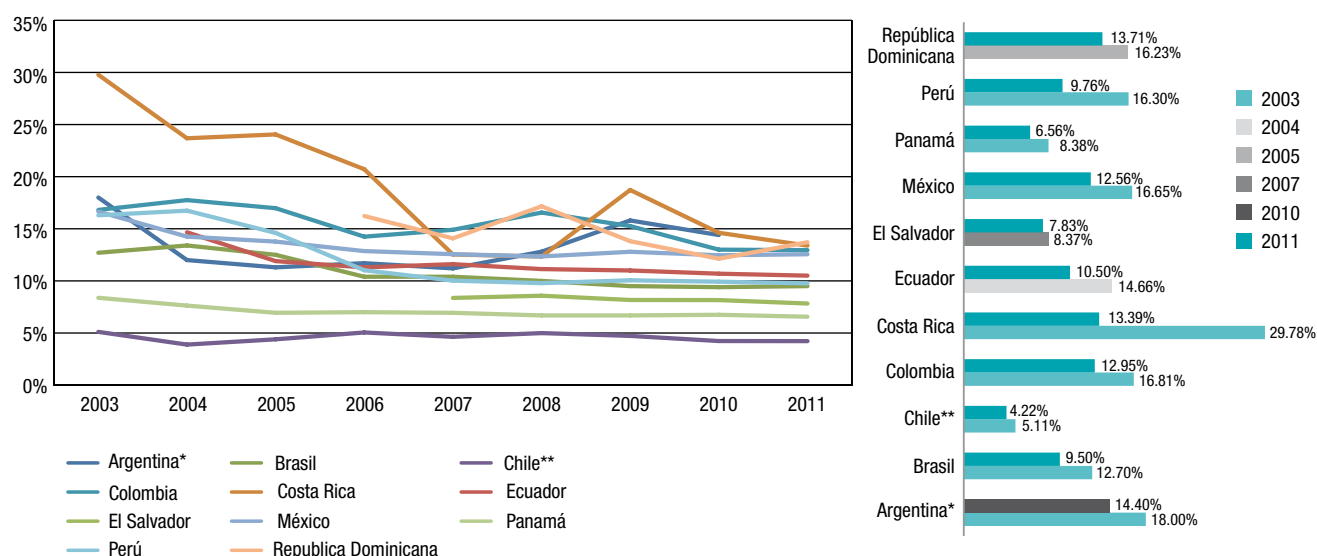


\* Includes portfolio of Social Housing Fund (FSV)

\*\* Does not include National Mortgage Bank (BHN)

Sources: Superintendence banking and finance, central banks, statistical institutes official, Titularizadora Colombiana, BBVA Research; Forums, Conferences and Seminars of UNIAPRAVI, and own estimates.

## Interest rate on housing loans in local currency 2003-2011



\* Data for 2010

\*\* In UF Unidades de Fomento

Sources: Superintendence banking and finance, central banks, statistical institutes official, Titularizadora Colombiana, BBVA Research; Forums, Conferences and Seminars of UNIAPRAVI, and own estimates.

rency, fixed rates, plus limits on loan-to-value ratios and payment-to-income ratios, among others, which permanently changed the housing finance system in Colombia. On the other hand tax incentives were given to investors, financial institutions, builders and borrowers, to boost the sector. Moreover, the establishment of the Titularizadora Colombiana<sup>1</sup>, in the early 2000s, contributed to increasing the funding for housing, default risk reduction, and improved of quality of bank portfolios.

With these reforms, although the sector's recovery was slow, the mortgage system fared well in the international financial crisis of 2007. There were also counter-cyclical measures such as increased housing subsidies and the coverage of

interest rate of mortgage lending<sup>2</sup> which allowed the momentum of housing finance provision to be maintained. An important conclusion is that in Colombia with the experiences of the crisis of 98, the banks learned to not originate sub-prime loans<sup>3</sup>. Between 2003 and 2011, Colombia reduced considerably mortgage default (Arrears as a percentage of mortgage balances) from 24% in 2003 to 2.6% in 2011.

## 5. The case of Brazil

In Brazil, high mortgage default also led to lawsuits and bankruptcies. In 1997 the Real Estate Finance System (SFI)<sup>4</sup> was created, and introduced the "Real Estate Loan" with scheme of "*real estate fiduciary assignment*", by which the property

remains in the name of the lender until repayment and thus became an attractive and safe mechanism compared to the traditional mortgage<sup>5</sup>. Since the early 2000s, the SFI system was perfected, by the creation of two instruments: "*Patrimônio de Afetação*" and "*Valor Incontroverso*"<sup>6</sup>. Currently in Brazil more than 90% of housing finance is through "real estate loan" (through the scheme of "real estate fiduciary assignment")<sup>7</sup>.

As well as the effects of the reforms and economic recovery, housing finance has been reactivated with the resources of the Brazilian System of Savings and Loan (SBPE)<sup>8</sup>, then with the state program My House My Life<sup>9</sup>. Mortgage default has reduced from 11% in 2003 to 2% in 2011, reflecting the success of reforms in the 90s.

<sup>1</sup> Titularizadora Colombiana is the first entity specialized in securitizing mortgage loans in Colombia; is a private institution, with shareholders that include International Finance Corporation (IFC) and institutions with ground history and standing such as BCSC, Bancolombia, Davivienda, AV Villas, Colpatría, and Seguros Bolívar.

<sup>2</sup> The coverage of interest rate in Colombia, is a subsidy to the interest rates of credit mortgages, of 3 to 5 percentage points, according to the value of the home; when the value of housing is lower the subsidy is greater.

<sup>3</sup> Maria Mercedes Cuellar, Seminar SUBPRIME CRISIS: WHAT WE LEARNED? EXPERIENCE COLOMBIA, Santiago de Chile, October 26, 2009.

<sup>4</sup> The SFI, sought primarily to channel resources to the housing finance with the securitization of home loans.

<sup>5</sup> Fernando Magesty, Marketing in the mortgage business and policies and strategies for the recovery of default portfolios, UNIAPRAVI, Notebooks Series No. 226, January-March 2011.

<sup>6</sup> *Patrimônio de Afetação*, in English means "equity separation", a device to preserve the development of projects of housing in the event of bankruptcy of the company. *Valor Incontroverso* in English means "undisputed value" a device to protect contracts credit value.

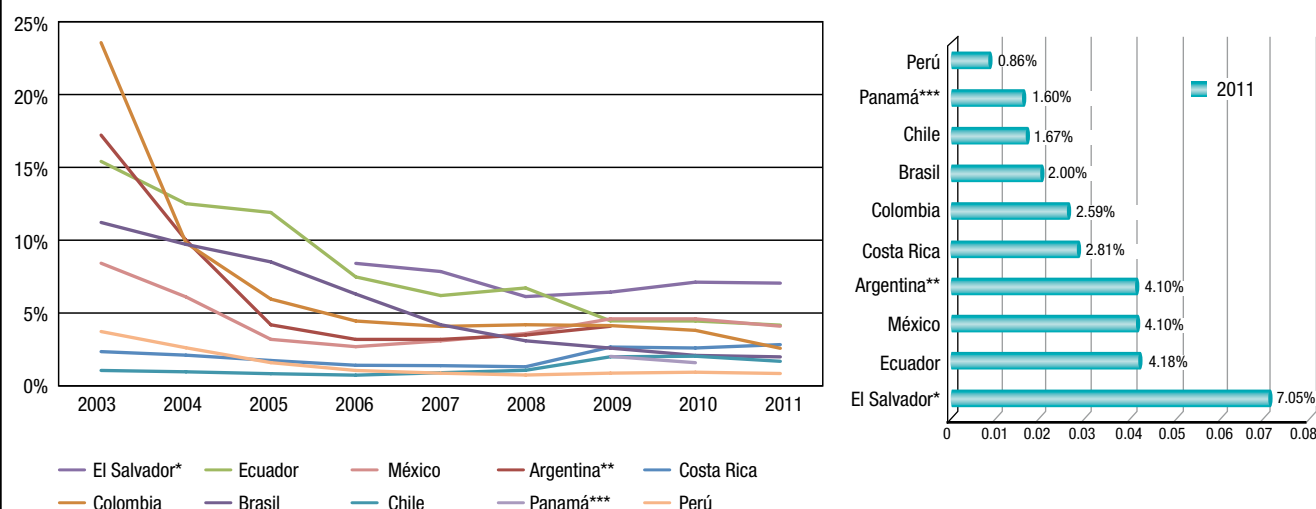
<sup>7</sup> In Brazil for housing finance the "Real Estate Loan" using the Real Estate Fiduciary Assignment is preferred to the traditional mortgage, because with "Real Estate Fiduciary Assignment" the property remains in the name of the lender until repayment and thus is a more safe mechanism in case of default.

<sup>8</sup> The SBPE, consists of Banks, Building Societies (SCIs) and the Savings and Loan Associations (APEs), operating with funds from savings accounts.

<sup>9</sup> The program My House My Life, is a federal program of Brazil, part of the Growth Acceleration Plan, as an anti-cyclical to face the international financial crisis, the program promotes funding 1 million homes between 2009 and 2010, and its second stage is planned another 2 million between 2011 and 2014.



### Index of default on housing credits in Latin American 2003-2011



\* Includes portfolio of Social Housing Fund (FSV)

\*\* Data for 2009

\*\*\* Data for 2010, Does not include National Mortgage Bank (BHN)

Sources: Superintendencia banking and finance, central banks, statistical institutes official, Titularizadora Colombiana, BBVA Research; Forums, Conferences and Seminars of UNIAPRAVI, and own estimates.

## 6. The case of Mexico

In the 90s, due to high levels of default, the departments of credits of private banking were converted for departments of collections; also were created massive restructuring programs with government support to help debtors<sup>10</sup>. With the withdrawal of private banks in 1995, the SOFOLES<sup>11</sup> emerged and played an important role in the housing market, because they reactivated the mortgage loans, financing the purchase of housing for different socioeconomic segments. In the 2000s, the Federal Mortgage Society (SHF) was created which assumes the administration of the Fund Operation and Financing (FOVI), and promotes the development of the secondary mortgage market, initially providing funding to SOFOLES, then providing guarantees and encouraging more standardization in the origination of mortgage credit. Another important factor was the modernization process started in 1992 of INFONAVIT, and then also FOVISSSTE<sup>12</sup>, improving processes and efficiency.

Private Banks returned to the mortgage market in 2005, and compete with SOFOLES, INFONAVIT and FOVISSSTE, and started the boom of housing finance in Mexico, now with better financial supervision and greater specialization in the mortgage business. Mortgage default fell from 8.4% in 2003 to 2.7% in 2006. The international financial crisis affected the Mexican economy; however, due the strength of mortgage system, mortgage default increased only slightly to 4% in 2011.

## 7. Argentina, Ecuador and El Salvador

In Argentina, in the 80s, the National Housing Fund (FONAVI) was restructured to create the Federal Housing System and the National Mortgage Bank (BHN) was reorganized and then privatized. During the early years of the 90s there was a significant recovery of the mortgage lending due to the economic recovery driven

by monetary reforms such as the Convertibility Law (peg) to counter hyperinflation of 80s<sup>13</sup>, but Argentina suffered a severe financial crisis in 2001, which impacted on housing finance until the present. Despite the vagaries of Argentina's economy, we see a significant reduction in mortgage default, from 17% in 2003 to 4% in 2009.

In Ecuador, the 90s were marked by high levels of inflation, unemployment, devaluation and interest rates of mortgage loans. In the 90s the Ecuadorian Housing Bank (BEV) was restructured<sup>14</sup>, from being a first-tier public bank to a second-tier to support banks, mutuals and cooperatives of the private mortgage industry. From the year 2001 Ecuador adopted the dollarization of its economy and started a new cycle, supporting the housing finance with operations of rediscount mortgages and housing subsidies, also in 2002 began operations the Mortgage Securitization Corporation (HTC) to promote the secondary mortgage market. The levels of mortgage default were reduced from 15.39% in

<sup>10</sup> Isidoro Sanchez, Evolution of Housing Finance in Latin America and the Caribbean, UNIAPRAVI, Notebooks Series No. 215-216, January-August 2008.

<sup>11</sup> Financial Companies of Limited Purpose (SOFOL), engaged in mortgage lending for house purchases and bridging loans to construction, and participate in the housing secondary market.

<sup>12</sup> Institute of National Fund for Housing for Workers (INFONAVIT) is the main financier of housing in Mexico, which operates with 5% employer's resources. The Housing Fund of the Institute of Security and Social Services for State Workers (FOVISSSTE) is directed to public sector workers.

<sup>13</sup> Jim Saxton, Argentina Economic Crisis: Causes and Remedies, June 2003.

<sup>14</sup> Salome Flores and Fernando Chiang, Evolution of Housing Finance in Latin America and the Caribbean, UNIAPRAVI, Notebooks Series No. 215-216, January-August 2008.



2003 to 4.18% in 2011 (including the portfolio of financial corporations and public banks); so if we consider only private banks, mutual and cooperatives, the rate of mortgage default was only 1.3% in 2011.

In El Salvador, in 1980 the banks were nationalized, including the Credit Institutions and Savings and Loan Associations, then in 1990 the banks were privatized, but due to poor public administration of these institutions, the financial system had to enter a restructuring process<sup>15</sup>. As public institutions since their inception the Social Housing Fund (FSV), in 1973 and the National Housing Fund (FONAVIPO), 1992, have played an important role in financing housing for low-income sectors<sup>16</sup>. In the 2001 El Salvador adopted dollarization and continued the reforms in financial system. Between 2006 and 2011 the rate of mortgage default remain relatively stable between 6% and 8%, including the portfolio of FSV. The rate of mortgage default for private banking was about 2.4% between 2006 and 2008, but has slightly increased since 2009, reaching 5.74% in 2011, because of the impact of the global financial crisis.

## 8. Chile, Costa Rica and Peru

In Chile, low levels of default are based largely on the strength of the financial system accompanied by an appropriate regulatory framework, whose transformation started with regulatory

reforms implemented after the 1982 economic crisis, when the government made modifications to the basic housing system and redefined and simplified their programs to improve the focus of housing subsidies, while in the 90s, the improvements continued, with deep decentralization to allocate housing resources and introducing changes to financing system<sup>17</sup>. Over the years Chile has consolidated its housing finance system, with improvements, which have promoted the lowest rate of mortgage default. In 2003 the rate of default was 1.06%, reaching 0.74% in 2006. After 2007 it increased to 2.01% in 2010 but fell to 1.67% in 2011.

In Costa Rica, in 1986 the National Financial System for Housing (SFNV) and the Housing Mortgage Bank (BANHVI) were established, BANHVI way to manage the resources of the National Housing Fund (FONAVI) and the Subsidy Fund for Housing (FOSUVI)<sup>18</sup>. The SFNV allowed more funding for housing with the active participation of private financial institutions, banks, cooperatives, and particularly of the mutual, which was reflected in the reduction of interest rates and less mortgage default, which averaged 2% between 2003 and 2011. In 2008 it was 1.32% and it increased to 2.81% in 2011, due to the impact of international financial crisis of 2007.

In Peru, reforms emerged in the 90s, after the hyperinflation crisis of the 80s, establishing a social market economy, with a new legal and

economic framework that provided the conditions for a return of private banking. With the creation of Mivivienda, in 1998, the promotion of the development of affordable housing and programs was implemented as "Mivivienda Credit", "Roof Own" and "Myhome"<sup>19</sup>. This generated dynamism in private sector, complemented by subsidies such as the "Family Housing Bond" and the "Good Payer Bond", a demand subsidy that encourages the timeliness of payments. The rate of mortgage default fell from 3.71% in 2003 to 0.86% in 2011, reaching its lowest level of 0.75% in 2008.

## 9. Conclusions

The main conclusion is that Latin America has implemented major economic, political, financial and legal reforms, after the deep crisis of the 80s and 90s; promoting improvements to the housing finance system, improvement and modernization to financial supervision and promoting greater participation of private banks. However, the major challenge remains to deepen the mortgage market in low-income sectors.

The improvement in the quality of the mortgage portfolio has been the result of a long process of reforms, and has been despite the impact of international financial crisis. Some countries had slight increases in the rate of mortgage default, but it has kept relatively low.

<sup>15</sup> Through the Privatization Program to Strengthen Financial System by the Central Reserve Bank of El Salvador, [www.bcr.gob.sv](http://www.bcr.gob.sv).

<sup>16</sup> René Escolán, Evolution of Housing Finance in Latin America and the Caribbean, UNIAPRAVI Series Notebooks No. 215-216, January-August 2008.

<sup>17</sup> Ramon Santelices, Evolution of Housing Finance in Latin America and the Caribbean, UNIAPRAVI, Notebooks Series No. 215-216, January-August 2008.

<sup>18</sup> Gerardo Meza, Evolution of Housing Finance in Latin America and the Caribbean, UNIAPRAVI, Notebooks Series No. 215-216, January-August 2008.

<sup>19</sup> Ronald Sanchez, Overview and Opportunities Housing Sector in Peru, UNIAPRAVI, Notebooks Series No. 218-219, January-June 2009.

# Housing purchases by foreigners in France<sup>1</sup>

↪ By Claude Taffin

## 1. Introduction

Since the creation of the Euro zone in 1999, French housing market prices have increased 2.5 times<sup>2</sup>. This increase has been rather homogeneous, unlike that of the previous cycle which mostly involved the largest cities favored by investors. The city of Paris has seen far above the average increase (3.2), mostly because of an unexpected boom in 2010 when investing in Paris was seen as a safe haven in the wake of the crisis.

When something goes wrong in France, it is customary to look for a scapegoat abroad. In this particular case, it is acknowledged that easier access to credit, with the combination of high loan-to-value, low interest rates and extended repayment periods, explains about half of the price increase. However, an alleged increase of foreign purchasers is sometimes thought to have contributed too.

What is the real extent of foreign residential investment in France? Who buys and where? Have there been noticeable changes during the last ten years? In particular, did the worldwide crisis of 2007 entail any qualitative or quantitative shift?

First of all, what are we talking about? The notaries' databases capture a range of data on real estate transactions (box). This includes information on the transaction (selling price, nature and description of the unit), the buyer and the seller. The reader should be aware that there are some limitations on the quantity and quality of this data, and also of coverage by the databases:

- The focus is on second-hand purchases (this definition has to do with taxation: in short, first-hand is subject to VAT and second-hand to transfer tax) because a majority of first-hand homes are built by a contractor and therefore not purchased from a developer, only the purchase of the land is captured by the database.
- The domiciliary purpose of the unit (main residence, second home or rental investment) is not known with certitude and may vary over time; it is therefore impossible to separate second-home purchases.
- The nationality of both the seller and the buyer is captured along with a number of other personal characteristics, but many foreign buyers are long-term residents and are therefore more likely to buy a main residence than a second home; for example, in Seine-Saint-Denis, the northern inner suburb of Paris, 14.5% of buyers are foreigners, of which only 0.5% are non-residents; symmetrically, a large proportion of non-resident buyers are French expatriates; for these reasons we will focus on purchases by non-residents who are not French nationals. We only consider the purchases by individuals. For a variety of reasons (often tax purposes) a number of buyers, whatever their nationality, adopt a corporate status, such as a limited partnership. We have no reason to believe that foreign buyers use this practice more than the French. However, this may distort the distribution of nationalities as this choice depends on the buyer's tax status.
- Because the coverage of the database is not 100%, the exact number of transactions is not

directly available; this number is estimated using the data on transfer taxes from the revenue service. These data are available by "département" but include no distinction according to the nature of the buyer and the proportions that we mention only concern individuals. For that reason, only proportions at the "département" level are reliable, absolute numbers of foreign buyers are not.

## 2. A sharp drop of foreign purchases after the subprime crisis

On average, over the decade (2002 – 2011), foreigners were 6.1% of all second hand housing purchasers and non-resident foreigners only 2.5% (table 1).<sup>3</sup> The 2008 crisis clearly had an impact: the proportion of non-resident foreign buyers was 2.8% between 2002 and 2007, and dropped to 1.9% after 2007. More precisely foreign purchases peaked in 2004 and started declining slowly thereafter. The crisis accelerated this decline, so that the share of non-resident foreign buyers halved between 2004 and 2011. Generally speaking, after 2004, the idea that French housing prices had begun to be overvalued increasingly spread and the crisis constrained a number of investors to reduce their investments abroad. There are probably other specific causes and the analysis must take into account the fact that a large majority of these buyers were British. By contrast, the share of foreign residents has tended to increase over time and the crisis had no impact on that trend, whereas the share of French non-residents is remarkably stable.

<sup>1</sup> The complete dataset for this article can be downloaded from the member area of the IUHF Website or is provided upon request by [weinrich@housingfinance.org](mailto:weinrich@housingfinance.org)

<sup>2</sup> Change of « Notaires-INSEE » second-hand housing price index between 1998 Q4 and 2011 Q4.

<sup>3</sup> Due to the abovementioned uneven coverage of the database, these aggregated proportions are biased downwards because the coverage is lower in rural areas where the proportions of foreigners are higher.

As already mentioned, we cannot calculate the absolute number of foreign buyers. However, given that the total number of transactions decreased from an approximate 820,000 per year between 2002 and 2007 to 700,000 between 2008 and 2011, the number of foreign purchases declined much more than the proportions show, by about 45% instead of 32%.

By contrast, the proportion of foreign non-residents among sellers appears to have been very stable, around 0.9%. It shows a negligible increase in 2006-2007 when the probability of further price increases became very slight (table 2). It is also remarkable that the crisis does not seem to have caused any increase in sales by foreigners. On the contrary, with stable proportions of foreign sellers and smaller volumes globally as noted above, they decreased.

The foreign non-resident sellers had been holding their property for a little less than 8 years. This is less than French sellers, should they be resident or not, whose holding periods are similar (close to 10 years). Foreign residents are in the middle (9 years).

### 3. The places where foreign non-resident buyers have most impact

In terms of the proportion of purchases by foreign non-residents, rural “départements” located in the west-central and southwest parts of the countries challenged the resort areas of the Riviera and the Alps. Number one, by far, is Creuse (19.4%), and next comes Dordogne (16%), whereas Alpes-Maritimes (15.2%) is only third. Three other “départements” have more than 10% of foreign non-resident buyers: Charente, Lot and Gers. They are both away from the coast and ski resort areas (Map 1). Haute-Savoie comes next (9.9%). It includes the Mont-Blanc area which has been attracting climbers for more than one century and the southern bank of Lake Geneva, less attractive, but much cheaper than the Swiss side.

These rural housing markets are very inactive. Therefore, if we were able to consider the total number of transactions, we would find that many more foreign non-residents buy a property in Alpes-Maritimes than in Creuse. However, we are focusing here on local impact and, for that purpose, the above proportions are relevant.

### 4. The British and the rest of the world

Who are these non-resident foreign buyers? We now limit the scope of this article to “la

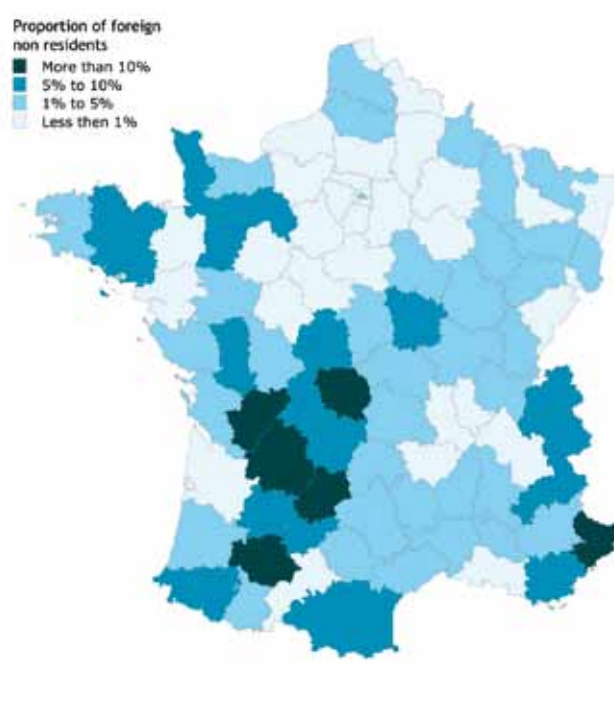
**Table 1: Proportions of second-hand purchases by nationality and residence status of the buyer (2002-2011)**

	Foreigners			French			All buyers
	Non residents	Residents	All	Non residents	Residents	All	
2007/2002	2.8%	3.5%	6.4%	0.9%	92.8%	93.6%	100.0%
2008/2011	1.9%	3.9%	5.8%	0.8%	93.4%	94.2%	100.0%
TOTAL	2.5%	3.6%	6.1%	0.8%	93.0%	93.9%	100.0%

**Table 2: Proportions of second-hand sales by nationality and residence status of the seller (2002-2011)**

	Foreigners			French			All sellers
	Non residents	Residents	All	Non residents	Residents	All	
2007/2002	0.9%	2.5%	3.5%	3.0%	93.6%	96.5%	100.0%
2008/2011	0.9%	3.2%	4.1%	2.1%	93.9%	95.9%	100.0%
TOTAL	0.9%	2.8%	3.7%	2.6%	93.7%	96.3%	100.0%

**Map 1 Average proportion of housing purchases by foreign non-residents by “département” between 2002 and 2011**

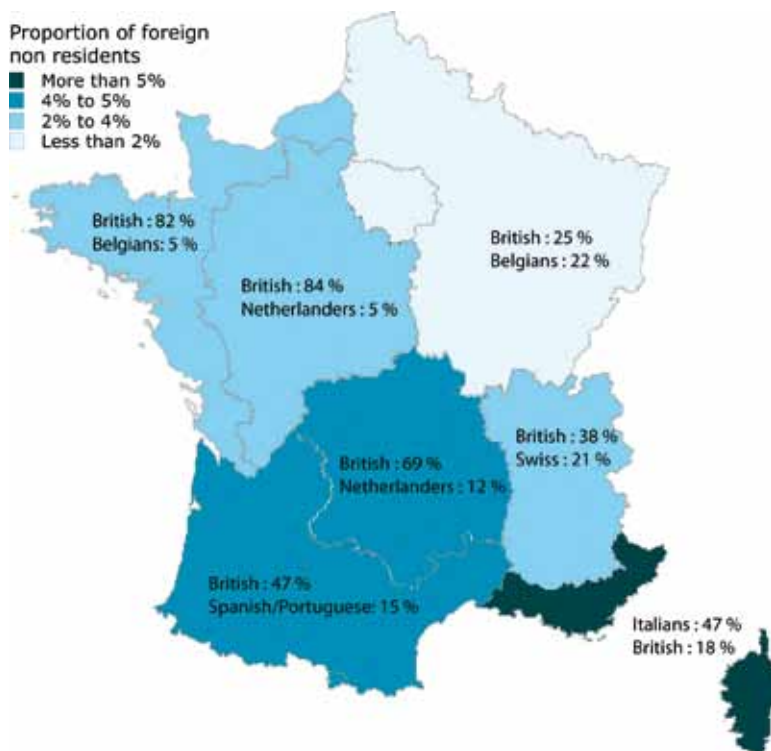


province” a condescending word when used by a Parisian to define all regions of metropolitan France except the Paris region (“Ile-de-France”).

In many respects, including real estate issues, the city of Paris is an exception, and the nationality of foreign purchasers is quite idiosyncratic. The Italians are number one, by far, and next come US citizens. Moreover, the purchase of an

apartment in Paris may be a rental investment instead of being for personal use, whereas the former case is quite unlikely in a rural area. The buyers in “la province” are totally different. On average, more than 40% are United Kingdom nationals (table 3). The crisis and the unfavorable exchange rate of the pound had a strong impact on British investors: their proportion as house buyers fell to under 30% between 2008 and

**Map 2 Average proportion of housing purchases by foreign non-residents and distribution by nationality (2002 -2011)**



**Table 3: Proportion of foreign non residents buyers by nationality in Provence (2002-2011)**

NATIONALITY	
UNITED KINGDOM	43.4%
ITALY	15.3%
BELGIUM	8.8%
NETHERLANDS	5.6%
SWITZERLAND	5.5%
SCANDINAVIA	4.1%
SPAIN/PORTUGAL	3.5%
GERMANY	3.5%
IRELAND	2.6%
OTHER EUROPEAN UNION	3.0%
USA	1.4%
OTHER	3.4%
<b>TOTAL</b>	<b>100.0%</b>

2011; they were replaced (in proportion, not in numbers!) mostly by purchasers from the Euro zone, such as Belgians and Italians.

Of course, there are some local differences due to the impact of neighbouring countries. The Italians who are the second buyers (15.3%) are numerous on the Riviera, and the Belgians who are third (8.8%) are not only present in the North-East but also in the South-West. Some nationalities, such as those from Russia or Gulf countries, will not be found in this data. This is probably because they only buy a few very expensive properties.

Living or spending holidays, regardless of buying a property, in France, has been a long British tradition. The British enjoyed staying on Côte d'Azur long before this name was given to the French Riviera. Promenade des Anglais, the famous waterfront boulevard in Nice was indeed built by English winter residents before Nice County became part of France (1860). This has of course to do with the quality of life. The economy, more precisely the variations in income, housing price and exchange rate, explain the changes in British housing investment in France (Friggit 2007).<sup>4</sup> Nowadays, the British do not dominate in the French Riviera any more, not because they

### Box: The Notaries' databases

There are two distinct notaries' databases:

- The "Bien" base, managed by the Chambre Interdépartementale des Notaires de Paris (CINP) covers the Paris Region. Coverage started in 1976 for Paris, 1991 for the inner suburbs (Petite Couronne), and 1996 for the outer suburbs (Grande Couronne);
- The "Perval" base is managed by Perval, a subsidiary of the Conseil Supérieur du Notariat (CSN). It covers Provence (all regions except the Paris region) and was set up in 1994.

These databases contain approximately 13 million records. Each year, between 650,000 and 900,000 transactions are added, among which about 500,000 that concern second-hand apartments and houses are used to calculate the "Notaires-INSEE" quarterly indexes.

The average rate of coverage is between 60% and 65%; it is higher in large urban areas (80% in Paris). A recent law (2010) made it compulsory to enter transactions into the databases and the rate of coverage is therefore expected to rise after the application decrees have been issued.

The transactions registered in the databases concern all types of properties, not only apartments and houses, but also buildings, business premises, plots of land, garages, vineyards, and other agricultural properties.

For each type of property, more than 130 variables are recorded, including: date of transaction, location and description (size, time of construction, equipment, etc.) of the property, financial data (selling price, registration fees, capital gains, credit), nature and qualities of the parties involved (nationality, age, profession), and recently environmental.

deserted it, but because they are being challenged by the whole world. Their first challengers are now the Italians (42.7%); the British lag far behind (18.4%) and, surprisingly given the low population of these countries, the Scandinavians (9.9%). A similar situation prevails in the Alps,

<sup>4</sup> Friggit, Jacques. 2007. "Comparing French and British Home prices in the Long Term", appendix 1 to "Long Term (1800-2005) Investment in Gold, Bonds, Stocks and Housing in France – with In-

sights into the USA and UK: a Few Regularities". Available on [www.cgedd.developpement-durable.gouv.fr](http://www.cgedd.developpement-durable.gouv.fr) (rapports et documentation).



where the British buyers (37.5%) are followed by the Swiss (20.5%), the Italians (9.8%) and the Belgians (9.7%) (Map 2).

There are other parts of the territory where there is much less challenge to the British, even by the French, because they are far from the seaside, from skiing stations and from most large cities. In these rural areas in the Massif Central the South-West and the West, we find proportions of British buyers among non-residents which may be well above 80%. In Brittany, Normandy and the Atlantic coast, the British are also more than 80% of buyers. They are also the majority (31.5%) among foreign residents. In all other regions, non-Europeans (mostly Maghreb nationals) come first. Finally, in a large North-East quarter, where tourist areas are few, the British share evenly the housing market with the Belgians and the Netherlands; Germans come fourth, but far behind.

## 5. The impact on local economy: the dark side and the bright side

The impact on the local economy is a complex issue which cannot be seriously looked at without gathering a variety of data on the local economy and local housing markets. This is out of the scope of this short article and we can only provide a few comments that would need to be supported by quantitative evidence.

The impact of non-resident buyers is apparent for all activities related to house purchase and construction. Developers, builders, estate agents, moving companies, house equipment including furniture, appliances, etc., and also for the notaries and the governments who share transaction taxes (3.6% for the “département”, 1.2% for the “commune” – city – and 0.49% for the state). All VAT on construction (19.6%) goes to the state’s budget and property (paid by the owner) and housing (paid by the occupier) taxes are shared between the four levels of local government.

There is a darker side for the local economy. The most popular resort areas (the French Riviera, the Alps, the Atlantic coast, not to forget the city of Paris) are often also the most populated areas. The local housing markets are therefore under pressure. Local workers face the –unfair– challenge of buyers or renters with higher incomes and they are compelled to live away from the core of the resort area. In the case of Nice, that is almost impossible, as the city is squeezed between the mountain and the sea, and is now the main centre of a metropolitan area of more than one million inhabitants. As a consequence, it is getting difficult for a local employer to hire non-qualified workers. A similar situation prevails in Paris.

One may argue that, due to their high purchasing power, the occupiers of second homes have a positive impact on the local economy, but this is only true depending on the amount of time they spend in these homes. In the central “arrondissements” (districts) of Paris (the 6<sup>th</sup> and 7<sup>th</sup>), where the average value of the square metre is about €13,000, many buildings are often empty because of the number of “pied à terre”. That issue does not concern foreign non-residents only, but more generally owners of second homes, which may well be French “provinciaux” or expatriates.

Switzerland has a unique law “Friedrich lex” which allows local governments to limit the number of foreign buyers. That would be illegal in the European Union, but limiting the number of second homes would be legal and this option is practiced in Austria. The French government recently considered discouraging purchases of second homes by non-residents through increased taxation but gave up when the French expatriates protested. However, that concerned only 11% of the 3.2 million second homes in France (which are 10% of the total housing stock).

In a much larger part of the “hexagone”, in particular in “départements” of the central part of France which are away from major traffic routes, such as Creuse, etc., little economic activity took over after a continuous rural exo-

odus in the last 150 years. Therefore the arrival of foreigners, from the United Kingdom, and the Netherlands in some places, helped revive a number of dying villages. A famous anecdote says that, to fly from Paris to Bergerac, it is easier to go to London first! These investors not only purchased second homes; a number of them settled for good, sometimes creating bed and breakfast in areas where the supply of tourist accommodation was under-developed while “green tourism” was experiencing an unprecedented boom.

Old village houses and farmhouses were sold for very low prices because there was little demand and they were in poor condition. Their renovation has boosted local construction and craftsmen’s activity and participated in the revitalization of many villages.

## 6. Concluding remarks

In spite of their imperfections and uneven coverage, the notaries’ databases allowed us to draw a picture of foreign investment in second homes in France. Traditionally, the British have always played the role of pioneers: after the Riviera and the Alps, where they are now challenged by many other nationalities, they have settled in rural areas far away from traditional resort areas. Their market share in the first years of the century was often above 80% among foreign non-residents.

This short article can only provide a quick overview of the dynamics of the markets. Focusing on the buyers is not enough, as people either do not settle for life or, on the other hand, they become long-term residents after buying a second-home. The global economy, through the recent crisis or the emergence of new economic powers, reshuffles the cards rapidly. The “nouveaux riches” from Russia, Brazil or Asia have not yet appeared in our data, but how long will it be before they do?

# The effectiveness of the French credit system faced with the challenge of budgetary restrictions

↳ By Bernard Vorms

## 1. A diversity of tenure

In France, 57.8% of households are owners of their primary residence; 42.2% of households are tenants; 44% of which are in social housing and 56% are in the private rental sector. 32% of homeowners are still mortgagors. 80% of homeowners have single family houses, while 74% of tenants live in blocks of flats<sup>1</sup>. Institutional investors have left the rented housing sector, 95% of the stock of private rented housing is in the hands of private individuals, the majority of whom own less than three dwellings. Most rented accommodation is in condominiums.

For nearly thirty years, every Government has encouraged home ownership while at the same time supporting the building of social housing, and investment in the private rental sector. In this respect the difference between right and left is chiefly about electioneering: the right parties proclaim their will for France to be a nation of home owners and the left simply want to allow those who aspire to it to become so, but in reality, political support for home ownership, has been very constant in its ways and means. The increase in the proportion of home owners has been steady, and there has not been the rapid

increases seen in the countries like the UK, or to a lesser extent the Netherlands, where social rented properties have been sold to their tenants. The last crisis didn't lead to a decrease in the proportion of homeowners.

In addition the residential mortgage debt to GDP ratio is very low in relation to comparable European countries even if it has increased steadily over the last years. The rate of debt of the average borrower has increased each year since 2007 (from 29.7% to 31.3%<sup>2</sup>). However, if the French public debt is significant, household debt remains very reasonable.

Nevertheless, in 2008, the subprime crisis resulted in a sharp drop in the number of transactions and construction projects. At that time the French economy underwent its most severe recession since the war, the availability of money for house building contracted sharply (-2.4% in 2009 after +4.3% in 2008), to settle at 430.7 billion Euros in 2009. This decrease was due to the historic drop in activity in the real estate sector, which returned to a level close to that of 2004 (-18.4% in 2009 after -3.1% in 2008). The collapse of investment impacted the purchase of newly built as well of existing properties<sup>4</sup>.

This crisis has not resulted in a credit crunch. The lenders did not ration their supply of credit, although they were accused of this; it is demand which was reduced. Some first time home owners withdrew from the market because they were frightened of the consequences of the economic crisis, while forecasts of lower prices encouraged others to wait and see. As for the buyers-sellers the fear of not being able to re-sell and the tightening of the conditions for bridging loans led to a postponement of purchases. Although there was not a generalised credit-crunch except perhaps for a short period, banks made their lending requirements slightly tighter, notably those which concerned the loan to value of bridging loans, but at no time did they change their attitude in response to an increase in risk in relation to current loans. Indeed, the mortgagors were not severely affected; the rates of default and re-possession barely increased.

From the point of view of lenders even the rise in unemployment has had no significant effect on repayments. It is without doubt in part because unemployment in the first instance affects the young and those with precarious jobs, who are more often tenants. Divorce and separation remain by far and away the principle reasons

**Table 1: Residential mortgage debt to GDP ratio, %<sup>3</sup>**

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
France	20.8	21.2	21.7	22.7	24.3	26.1	29.3	32.1	36.7	39.0	41.2
Royaume uni	55.1	55.8	58.0	62.1	67.4	71.2	77.5	82.2	80.4	87.7	85.0
Espagne	26.7	29.9	32.5	35.9	40.0	45.7	52.3	58.1	62.0	64.4	64.0
USA	63.8	70.0	63.5	59.0	56.4	67.2	88.9	83.3	86.5	82.4	76.5

<sup>1</sup> Source MEDDTL Comptes du logement mars 2011

<sup>2</sup> Source SGACP/Autorité de Contrôle Prudentiel

<sup>3</sup> Source EMF HYPOSTAT 2010

<sup>4</sup> CGDD: MEDDTL Comptes du logement mars 2011



for borrower default. In spite of a marked increase, compared to the levels of the years 2004-2007, the cost of default remains at a very low level (0.08% of outstanding loans in 2010). The amount of loans classified as in default rose slightly compared to 2009, to 1.29%, but remains low; provisions for non-performing loans have decreased for its part regularly since the peak of 42% reached in 2005 and now stand at 30%<sup>5</sup>. The claims rate remains among the lowest in Europe and “negative equity” is not subject to any overall estimate. To what extent is this situation explained by the characteristics of the French credit system, and how is the housing sector likely to evolve now that budgetary restrictions have led to a reconsideration of the extent of public support for housing?

## 2. An offer of credit to financially stable households

In France, the terms of credit are quite favourable to those who borrow money to buy a house. Competition between the institutions is fierce; so that rates are lower than most of our neighbours, except Germany<sup>6</sup>. They are quite “egalitarian”, because at any given time, the loan conditions are not linked to the income of the customers. In short, the default rate is low and foreclosures are exceptional. But some consider that the downside of this satisfactory situation is the overly restrictive nature of the offer. Already, prior to the Crisis, several new mortgage products had been introduced into the market which were intended to diversify the supply of mortgage products, in particular the introduction of reverse mortgages and equity release loans. Just before the Crisis, the author was entrusted by the government with an exploratory report<sup>7</sup> to facilitate access to credit to those currently excluded, principally, people with non-permanent contracts and the elderly who were unable to obtain life insurance linked to the loan agreement. As the report was submitted after the bursting of the subprime bubble, those of its recommendations that involved a change in the law have been set aside.

### 2.1 A majority of universal banks

Over the last decades the home credit supply has seen market mechanisms replace, by

stages, the dedicated financing schemes<sup>8</sup> put in place by the Government at the beginning of the 50's. These schemes of credit which have for a long time represented the vast majority of the supply have left room for private market banks. Today, the key to the supply of housing finance is held by a small number of powerful networks dominated by so called universal banks: Crédit Agricole SA, which has absorbed the Crédit Lyonnais; Caisses d'Épargne which has merged with the network of the Banques Populaires to become BPCE; Crédit Mutuel which bought CIC and the BNP which bought another specialised institution (Paribas) and last, Société Générale and la Banque postale. More than 85% of new housing loans are made by universal banks: in 2005 this percentage rose to its highest level of 88%<sup>9</sup>. Moreover, among the “specialised” mortgage lenders, only the Crédit Immobilier de France was, when this paper was written, still independent, as the Crédit Foncier belongs to BPCE.

Social rented housing still has its own dedicated financing schemes. Loans offered by the Caisse des Dépôts et Consignations are, largely backed by a regulated savings product, the “Livret A”, the interest of which is tax exempt. This was previously held only by the Caisses d'épargne (saving and loans), including those managed by the Post Office, which became La Banque Postale. The “Livret A”, is now offered by a number of banks, but part of the resources collected are necessarily pooled by the Caisse de Dépôts et Consignations, which uses them to finance social housing. This part of the market is not addressed further in this article.

The various stages of the mortgage process are not handled by separate institutions as they can be in the United States, where the process is unbundled between the broker, who sells the credit, the originator, who keeps the relationship with the borrower, the servicer, and the investor, who holds the mortgage-backed securities. While the share of loans brokered by agents and go betweens has increased over the last few years, it still remains very much a minority, probably lower than 20% and the banks never delegate to these intermediaries the authority to grant the loan. The institution that approves the loan, manages it until it is fully amortised and usually holds it on its balance sheet throughout

that period. Therefore arrears and defaults have a direct effect on their financial results, except those arising from loans to the lower income first-time homeowners, which are guaranteed by the *Fonds de Garantie de l'Accession Sociale*, and described below.

### 2.2 A personal approach to credit

For the universal banks, with savings inflows from individuals, the home loan is largely a means to develop customer loyalty or a means of gaining new customers; banks lend to their customers or to those who will become customers. They require borrowers to pay their income into the bank via direct debit. But, while the lenders in most countries take into account the value of the property as security (to the point where the term mortgage implies both a guarantee and a secured loan) and also the income of the borrower, the French with very few exceptions focus their attention solely on the creditworthiness of the borrower. This is why the lender almost never asks for a valuation, even though it is going to provide the finance: the value of the security is assumed to equal the amount of the transaction or the price of the construction project. Nevertheless, credit files containing positive data do not exist. On the other hand, banks tend to exclude potential borrowers who are not in stable employment or who are not insured against death or disability.

### 2.3 Credit access and lender security

It is impossible to obtain an accurate picture of the origin of the sources for funding loans. The banks, which have an overwhelmingly predominant market share, have substantial internal resources through deposits, capital market funding (bond issues) and regulated savings schemes, like “épargne-logement”; “Epargne-logement” is a regulated product that benefits from preferential tax concessions. It is a legal requirement that a part of the money collected for this scheme must be used to finance housing loans. In general, although the proportion of the funds collected in the market increases, the use of specific financial products instruments is low: at the end of 2005, outstanding covered bonds totaled 64 billion Euros, bonds issued by the *Caisse de refinancement hypothécaire* were worth 18 billion Euros and the securitised real

<sup>5</sup> Cf. <https://www2.sfgas.fr/web/guest/presentation-sfgas1>

<sup>6</sup> This judgment was made in a study from the Office/Law Firm of Mercer Oliver Wyman before the Crisis.

<sup>7</sup> Claude Taffin & Bernard Vorms: “Elargir l'accès au crédit des emprunteurs atypiques”, 2007 [http://www.anil.org/fileadmin/ANIL/Etudes/2007/acces\\_credit\\_emprunteurs\\_atypiques.pdf](http://www.anil.org/fileadmin/ANIL/Etudes/2007/acces_credit_emprunteurs_atypiques.pdf)

<sup>8</sup> Schemes which combined pooling of earmarked resources such as specific dedicated accounts and a dedicated lender.

<sup>9</sup> Hors prêts aidés. Source : Banque de France

estate debt fund was around 10 billion Euros, while the outstanding housing loans to households stood at 498 billion Euros. Securitisation plays a minor role. The development of investment products that characterized housing finance was associated with none of the abuses which, elsewhere, allowed the lender to transfer the debt and to become disinterested in the final repayment of the loan. So, neither the working of the mortgage process, or the nature of loan security allow the lender to cut the link with the borrower until the loan is fully amortised.

### 2.4 Death and disability insurance

If credit institutions bear the consequences of losses associated with the loans they grant, certain practices allow them to protect themselves from the consequences of what one would call “the risks of life” (death, unemployment...). Thus, no credit is granted without a death and disability insurance policy in respect of the borrower. This is a cause of the restrictive nature of the supply of credit to the elderly. While it is not a legal requirement it is a unanimous requirement of lenders. In case of death of the borrower, the loan is re-paid by the insurance and the lender does not have to worry about pursuing their estate for repayment, which is particularly helpful given that French inheritance law is rather complex. It is also a protection for the beneficiaries of the estate, whether it is a surviving spouse or children, but it is also an important contribution to net banking income, since almost half the insurance premium is returned to the lending institution that manages the insurance policy as a group policy on behalf of the insurer. Recent legislation has aimed to improve competition in the field of death and disability insurance; it forbids the lending institution to make the loan conditional on the take up of their own group policy if the borrower offers a policy from a competitor organisation which has the same guarantees. For all that the pre-existing situation has not significantly changed.

### 2.5 “La caution”, a French exception

The caution (bond insurance) is an unconditional guarantee given by a specialised financial entity. This specifically French system of Surety reduces risk to the bank. Nearly 60% of all loans are not registered as a mortgage<sup>10</sup>. The mortgage security is replaced by a guarantee provided by a specialised body. This guarantee is the under-taking, pledged by a third party, the “Caution”

to pay the borrower's debt in case of default. In return for a fee, the “Caution” agrees to pay the bank the amounts owed by the borrower if the latter defaults. It simply has to be shown that the borrower has defaulted for the guarantee to come into force which, at the first request, must be paid by the guarantor. Moreover, if the credit institution wishes, most “caution” companies take charge of the debt recovery process in case of default. The benefit of this guarantee on the mortgage is evident to the lender: it ensures the return of its funds within a short period, and at the same time removes the management of contentious issues. The paper work for obtaining a guarantee is less than for a mortgage and does not need the intervention of a notary. The decision to accept or reject an applicant is, in general, very quick. In the case of late payments, the guarantor who has paid the debt takes on all the rights which the creditor had against the debtor. If an amicable solution is not found, the guarantor can put in place a “judicial mortgage”, and use all available ways of enforcement. The “Caution” companies also differ in their status: some are credit institutions, others are insurance companies. Finally, the cost of the guarantee is determined so as to be less than that of a mortgage deed and it is a very profitable activity which feeds into net banking profits, since most of the mutual guarantee companies belong to banks.

A quick examination would lead one to believe that there is a similarity between the “Caution” and private mortgage insurance in America and mortgage indemnity insurance in the United Kingdom. These are arranged to cover the part of the loan that exceeds the value guaranteed by the mortgage. By transferring part of the risk to the insurer, irrespective of their terms these types of insurance are designed to allow access to credit for borrowers with very little down payment. However, these insurance policies are different from the “Caution” in three essential respects. Firstly, in legal terms, these insurances are complementary to the mortgage which is still required in all cases, whereas the “Caution” is an alternative to a mortgage deed. Secondly, the “Caution” guarantees all of the debt. Thirdly, in terms of function, mortgage protection insurance is required when the percentage of the loan to value is higher than a certain percentage, 70 or 80%; on the contrary the “Caution” insures those cases with the least risk, especially those with a low loan to value ratio.

However, the dominance of the “Caution” in the French system could be jeopardised if the project of the European capital requirements directive n°4 is enforced without any change since it does not take in account this kind of guarantee.

### 2.6 The guarantee fund for social home ownership<sup>11</sup>

At the other end of the risk spectrum is the public “guarantee fund” for low income home ownership which is used to reduce the risk for the lender. When the state in 1995 was preparing to remove dedicated financing schemes, it wanted a reassurance that low income first time home owners would not be excluded by a too selective credit policy being applied by some banks and the ability to obtain an offer of credit on conditions similar to those with higher incomes. It is from this perspective that the Guarantee Fund for Social Ownership was established. It guarantees the risk for the lender without taking responsibility to manage their risk. It also helps lower the mortgage rates offered to modest borrowers in two ways: on the one hand, by compensating part of the costs of default, and on the other by inducing an economy of equity capital thanks to the guarantee given by the Government in case of depletion of the fund. Thus it keeps down costs for the lenders allowing it to give almost the same interest rate to low-income and affluent borrowers. The guarantee plays in case of borrower default, to compensate for all losses defined as a decrease in the actuarial rate of return expected by the credit institution granting the loan, taking into account ancillary expenses incurred in relation to the debtor. Finally, it is a guarantee of last resort, which, in principle, is used only when all other guarantees or sureties have been used. The fund requires that the loans which it guarantees are secured by a mortgage guarantee. At its inception, the fund was funded equally by contributions from credit institutions and the Government. In 2005, the very low level of claims since the establishment of the Fund led the government to recover money that had been accumulated in the scheme. The scheme has remained the same, but the fund was replaced with a direct guarantee given by public authorities.

### 2.7 Consumer protection and information

A final aspect that must not be neglected seeks a fair working of the housing finance sector.

<sup>10</sup> Surety from Lending Institutions or Insurance Company Guarantees accounted for 59% of housing loans taken out by individuals in 2010. (Source SGACP/Autorité de Contrôle Prudentiel).

<sup>11</sup> Source : SGACP, Autorité de Contrôle Prudentiel.

France has very strong and effective regulation in relation to the provision of consumer information and protection, particularly as regards the borrower. This attitude is reinforced by the strict approach that judges and the legal framework have in relation to lending to individuals. This should be seen as a reflection of the emphasis that French society places on responsible lending, and indeed an attitude of mistrust in respect of credit.

What are the key elements to this?

**The law on usury** forbids a lender to deviate by more than one third of the average rate of interest charged for loans of a similar nature, which, in times of low interest rates, represents a very narrow margin, e.g. 1.33% when rates are 4% against 3.33% when they rise to 10%. From the perspective of the institutions who would like to focus on non-conforming customers, who represent a higher risk, or involve higher underwriting costs, the current regulations in relation to low interest rates constitutes a major obstacle. While the methods of fixing the usury rate are criticised, in that it increasingly restricts access to credit while the rates are low, the legal principle of a cap to the rate is not questioned by anybody in France. However, these provisions, in the low interest rates conditions which have characterised the last decade, make it impossible to price an increased risk too much above the average rate. If somebody had wanted to sell "subprime" in France, and some institutions were tempted to do this, the relative inflexibility in the interest rates would have prevented it.

**Equity withdrawal** is not practiced. Indeed, in order to limit the risks, the law that introduced equity release in France banned revaluation of the security being amortised. Therefore, it is impossible to benefit from rising house prices by borrowing against the capital growth; this is one of the major dangers of mortgage equity withdrawal, which at the same time is also one of its main attractions.

While **amortised loans at fixed rates** account for the vast majority of the loans made, more than 87 % in 2010<sup>12</sup>, the law puts a ceiling on the compensation for early repayment of a fixed loan at 3 % of the outstanding debt or six months interest. In the case of occupational

mobility or of death, no prepayment penalty can be demanded.

Finally, in all the French departments, the Ministry of Housing manages, in partnership with local authorities, housing professionals and associations, "**ADIL/agences départementales d'information sur le logement**"<sup>13</sup>, housing counselling agencies, whose job it is to offer free impartial advice to the public on all housing issues. Those considering buying a house can explore their individual purchase and financing plans with an independent specialist, who has links with banks and other professionals. It is important to note that these advisors have absolutely no intermediary or brokerage role.

## 2.8 A halt to the progress of the integration of the European mortgage markets?

Many of the features described above that explain the fact that French borrowers went through the crisis relatively undamaged were, prior to the crisis, seen as obstacles to the creation of an integrated European mortgage market<sup>14</sup>. Examples mentioned include "the restrictions on interest rates as the rules prevent usury, the compulsory ceilings for variable interest rates, the proposed ban on interest accrued, etc.) practiced by some countries which may hinder the movement of certain goods and services from one country to another"<sup>15</sup>. It is doubtful whether following the subprime crisis France is more likely to give up its very high level of consumer protection.

## 3. Following the crisis - the fiscal austerity measures

The way France has weathered the crisis has demonstrated that its housing finance sector is secure. The approach which may be too restrictive was hitherto compensated by the significant public financial involvement that France allocates for housing policy, nearly 2% of GDP, if we add up all kind of supports, budget support, tax subsidies. ... The largest part, 16 billion euros, or 43% goes in housing benefit, mostly housing benefits paid out to tenants, but investment grants are also very important. Those that can

be assigned are distributed 58% to the social rented sector, 34% to owner occupiers and 8% for investment in the private rental sector<sup>16</sup>. In addition to the objective of growth and improvement to the housing stock, housing policy is one of the main drivers of macroeconomic management that governments have relied on during periods of economic downturn. Supporting employment in the construction sector and maintaining a consistent level of activity are stated objectives of housing policy. France has not experienced a high volatility in the level of activity or price that can be seen in countries like US or UK. In the social rented sector there are long delays between the decision and the impact on employment. Conversely, it is newly built construction, intended for home ownership that is most dynamic because it is predominantly concerned with building single family house. However, the fiscal austerity measures in 2012 may deprive the government of a support tool for the economy which proved very effective in the 2009-2010 stimulus package.

### 3.1 The stimulus package

The stimulus package introduced in 2009 was based both on support for the construction of social rented housing, tax incentives for investment in the private rented sector, and also very generous subsidies to encourage the construction or the purchase of new housing by low-income households. During 2010, output increased sharply (+52%), reaching 165 billion Euros. Of this amount, in 2010, the share of funding for investment in rental property remained at a high level (18%) without any significant change from 2009<sup>17</sup>. Approximately 800,000 transactions of existing homes were recorded in 2010, an increase of almost 25% over the previous year, and a level close to the highest ever recorded in 2005. The marketing of new housing, if somewhat less dynamic, nevertheless experienced an upturn, the number of sales being around 115,000 for the year 2010, almost 10% more than in 2009<sup>18</sup>.

### 3.2 The austerity budget for 2012

The Finance Act for 2012 includes a significant reduction in aid for housing, mainly for rental investment and home buyers. Tax assistance for private rental investment has been greatly

<sup>12</sup> Source : SGACP, Autorité de Contrôle Prudentiel.

<sup>13</sup> <http://www.anil.org/>

<sup>14</sup> Cf. The report published in August 2005 by the London School of Economics for the European Commission (DG internal market and services) on the costs and advantages of mortgage market integration expresses it clearly enough.

<sup>15</sup> Idem cf. LCE report

<sup>16</sup> Source : Comptes du logement pour 2009

<sup>17</sup> Source SGACP/Autorité de Contrôle Prudentiel

<sup>18</sup> Source: Chiffres et Statistiques du Commissariat général au Développement durable – no. 220, mai 2011



reduced and will be removed later this year. From 1988 to 2006, the private rental market has increased by about one million units from 4.6 to 5.7 million homes. This increase is generally attributed to the effects of the fiscal incentives for rental investment; the first came into being in 1985<sup>19</sup>.

As for the zero-interest loan, the PTZ/*prêt à taux zéro*<sup>20</sup>, the principal instrument of financial assistance to home buyers, this has radically changed once again, less than a year after its previous reform. The savings expected from this last measure are of 1.8 billion Euros, resulting in 800M€ outlays for 2012, against 2.6 billion Euros in the current configuration in 2011. The income ceiling that gives entitlement to aid, which was abolished in 2011, has been restored, and its existence is no more really disputed. At the same time, the scheme has been limited to new homes only.

The PTZ, replaced by the PTZ+ is a complementary subsidised loan granted, subject to certain income-related conditions, to first-time buyers. It is the primary public aid measure available to encourage access to homeownership. In 2012, the PTZ+ is once again reserved solely for newly built homes. The liveliest debates have been about the geographical targeting of aid. Should we direct financial aid to areas where the housing supply cannot meet demand, or to the less expensive areas where the incentive to buy is the more efficient? It is the latter choice that was made thus choosing to support jobs in the construction industry rather than building in areas where the imbalance between supply and demand is most pronounced.

How many transactions and building operations will be carried out in 2012? We know that in the first quarter of 2011, 75% of PTZ+ have been granted for the purchase of existing homes, and among the transactions financed by new PTZ+, 71% were located in the less stretched, i.e. less expensive areas. However, it is not possible to draw detailed conclusions retrospectively about the proportion of these transactions that would have been set up in the absence of PTZ+, not least because the efficiency of PTZ+ is likely to be much greater for buying a newly constructed home than for buying an existing dwelling. Similarly for new construction this stimulation effect diminishes as prices rise, so with the strength of the market in the areas of highest demand, because subsidising access to credit does not compensate for lack of down-payment; in very expensive areas, assets are more important than income<sup>21</sup>.

### 3.3 Towards a tighter supply of credit?

The difficulty is compounded by the fact that these measures come at a time when banks could be driven to restrict credit supply for two reasons: the current liquidity crisis and the directives of the Prudential Control Authority of the French Central Bank.

In contrast to what can be observed in many other countries, it is not an increase in default rate that would prompt banks to raise their prudential requirements, but their difficulty in obtaining enough resources to finance loans. This liquidity crisis in the euro zone comes as the

long term refinancing requirements of banks are increasing: the funding of loans is done through the increasing use of market and prudential requirements, known as "Basel 3" covered by the rate reserve requirements.

At the same time the Prudential Control Authority of the French Central Bank directed the lenders to limit the length of loans and to increase their requirement for capital. These rules are intended to contain too rapid growth in outstanding household mortgages. What is at stake, in the eyes of the French Central Bank, is the systemic risk which is demonstrated by an increase in loan volume much greater than the growth in GDP, which would fuel rising house prices. The lowest-income first-time homeowners of 2009 and 2010 took advantage of exceptional conditions: massive public aid, low interest rates, long length loans and no requirement of down-payment. Unless prices fall or there is a takeover by second time buyers there is a danger of a decline in activity.

This would occur when, for several years, the idea of a "housing crisis" and a general housing shortage has been dominating discussions between the representative bodies of the main housing market players and government. Therefore two questions are raised. Can the current structure of the sector maintain production of housing at sufficient levels? At a time when there is a real threat of recession can the housing sector still play its role in supporting economic activity and employment?

<sup>19</sup> Cf. Jean Bosvieux Habitat actualité Janvier 2012/Comment empêcher l'érosion du parc locative privé?

<sup>20</sup> The PTZ, replaced by the PTZ + is a complementary loan granted, subject to certain resource-related conditions, to first-time buyers. It is the primary public aid measure available to encourage access to homeownership.

<sup>21</sup> In Paris, to take the example of the most expensive market, the price of a new apartment of 80 m<sup>2</sup> accounts for over 20 years of household income for the Paris region's median decile. Buying a new home is only possible if the household makes a very large personal contribution; on the other hand, many first-time buyers in the small low-density areas finance their entire purchase through borrowing.

# Towards cost effective private financing of affordable rental housing<sup>1</sup>

↪ By Julie Lawson, Vivienne Milligan and Judith Yates<sup>2</sup>

## 1. Housing finance markets by design

A critical issue facing countries such as Great Britain, Australia and the Netherlands, is how to reinvigorate residential construction in times of fiscal constraint and credit squeeze. We know that adequate housing supply is not only important for those who need a place to live, but also integral to stable economies and housing and labour markets. After several decades of public sector withdrawal from direct financing of social housing and increasing reliance on private investors, the commercial sector is unwilling to fill the gap at reasonable cost under today's turbulent financial conditions. Private finance has been a fair weather friend.

More than ever before there is a need for strategic public measures to channel and lower the cost of private investment in the affordable segment of the rental housing market and, in particular, to ensure that this housing can be accessed by lower income tenants. This article outlines a proposal, developed for Australian conditions, that shows how conditional public subsidies, private housing supply bonds, a special purpose intermediary and regulated not-for-profit providers could be utilized to address the growing need for affordable rental housing. It is inspired by the successful Housing Construction Convertible Bonds, which continue to channel considerable funds towards the limited profit housing sector in Austria. A research report and strategy for implementation was presented to Australian governments in May 2012 and any response will unfold during the coming year.<sup>3</sup>

## 2. Persistent affordability and supply problems

The supply of affordable housing continues to be one of the most persistent problems facing developed countries over the last quarter of a century. One contributing factor is the limited availability and increasingly high cost of private finance. This article builds on a concept outlined in an earlier HFI article (Lawson et al, 2009) and concerns specific measures governments can take to promote lower cost investment in affordable rental housing. It presents recent work funded by the Australian Housing and Urban Research Institute, designing an instrument and financial intermediary suitable for Australian conditions.

There are of course many other factors affecting affordability across Western Europe, North America and Australasia including the high cost of residential land; sluggish suppliers and variable lending conditions. Combined, these have not served the needs of low and, increasingly, middle income households well (UN Habitat, 2011). Home ownership for all, via direct assistance to individuals (grants) or broad fiscal measures (deduction of mortgage interest) has proven to be a costly and ineffective strategy, failing to lift supply and, in some countries, causing undesirable fiscal outcomes and unintended market outcomes. In traditional home owner countries such as New Zealand and Australia, home purchase now occurs later in life and ownership rates have plateaued or are falling, despite two decades of government promotion, cheap mortgage credit and, until recently,

a widespread belief that house prices would continue to rise (Morrison, 2008, NHSC, 2010). Ownership is now out of reach for an increasing proportion of households. Despite the need for affordable housing, construction has plummeted in all countries mentioned above except those with active government-facilitated supply side programs (Austria), where stable housing markets have been a central goal of economic policy for many decades and construction rates remain stable despite the Global Financial Crisis (GFC) (Czerny and Weingärtler, 2007, Amman and Kratschmann, 2011).

This situation is forcing policy makers to reassess the role of the rental sector and revise current supply policy settings. Indeed, if rental housing is to become a mainstream and long term option for more households, then ideally governments should promote a well-functioning rental market, which serves a range of household types and incomes. We know that in times of scarcity, liberal rental markets do not serve lower income tenants well, and even in the best rental systems, a lack of affordable housing opportunities means that poorer tenants are concentrated in the worst rental accommodation.

## 3. Australia's need for affordable rental housing

Australia has one of the smallest social housing sectors in the developed world and relies heavily on its liberalised purchase and rental markets to provide for a broad spectrum of housing

<sup>1</sup> This article relates to a paper given to 6th Australasian Housing Researchers' Conference 8-10<sup>th</sup> February 2012 The University of Adelaide, South Australia, now under review.

<sup>2</sup> Julie Lawson is an international housing researcher and urban planner at the AHURI Research Centre RMIT University, Australia. Vivienne Milligan is a housing researcher at the City Futures

Research Centre, University of New South Wales, Australia and Judith Yates is an economist at the School of Economics, University of Sydney, Australia.

<sup>3</sup> Details can be found in the final report available at <http://www.ahuri.edu.au/publications/p30652/>

needs and capacities. In recent years, housing affordability has become a wide social concern, yet has received sporadic and fragmented political attention. Social housing supply has long been unable to keep pace with demand, despite recent initiatives and stimulus measures directed towards this goal. While there was considerable public investment following the GFC to encourage expansion of the supply of affordable housing by 2011, an additional 90,000 dwellings would still be needed just to restore social housing to its 1996 share of the housing market. On current policies, this shortfall is projected to increase to almost 200,000 by 2021, on the basis of medium projections of household growth.<sup>4</sup> The cost of meeting this would amount to around \$7 billion per year.<sup>5</sup>

Current levels of public funding certainly cannot generate the required increases in the supply of affordable rental housing and the high cost of commercial loans to non-government housing providers limits their capacity to grow. It is clear that additional measures are required to channel and sustain adequate levels of private finance to achieve even the most conservative targets of the Australian Government's National Housing Supply Council.

### 4. Reducing the cost and channelling investment

The cheapest – and simplest – way to finance any increase in affordable housing is for governments to provide direct grants or loans to public or community housing providers, as has been the approach in many countries in previous decades. While this may be economically desirable it is not politically likely. Australia is in a unique position amongst developed economies, with low government debt and stable, positive economic growth. However, despite the historically low cost of issuing Australian government bonds, all-pervasive fiscal austerity policies mean that public budgets are highly constrained and governments are very reluctant to take on additional debt. Efforts are further undermined by the fragmentation of responsibilities for housing policies across various government

departments responsible for revenue management, economic development, infrastructure, the environment, and welfare matters.

In this context, there has been growing interest across the housing research and policy community in the development of a financial instrument and intermediary to attract private capital investment to the non-government not-for-profit sector to deliver a range of social goods and services. Further there are national financial ambitions and related reforms to expand the corporate bond market in Australia and provide greater access to retail investors. In 2010, a Productivity Commission report on the not-for-profit sector (Productivity Commission, 2010) highlighted that a lack of access to (private) capital and the absence of specialist financial intermediaries to service this sector were two factors hindering its overall development. Subsequently, a Senate inquiry has examined in more detail “the barriers and options available to develop a mature capital market for the social economy sector in Australia” (The Senate Economics References Committee, 2011: xix). The proposal for Housing Supply Bonds outlined in this article is consistent with these various developments.

### 5. What kind of investors?

Once government budget constraints are seen as immutable, raising finance in the private market, such as from banks, individual investors and superannuation funds becomes the only feasible solution. However, experience has shown that accessing private finance for Australia's emerging affordable housing industry brings its own challenges. Unlike in the UK where substantial public co/financing and revenue assistance measures have been in place for over two decades, Australian banks have only been willing to provide limited funds to not-for profit housing organisations, and these have been costly and have required significant revenue support and collateral security. Interest rates charged have exceeded the standard mortgage rate (often by a considerable margin) and borrowers have faced an interest cover ratio of around 1.5 to 2.0 and loan to valuation ratios as low as 15 per cent. A shortage of long term credit and

the post global financial crisis (GFC) regulatory requirements on banks are likely to reinforce these current constraints.

A second option is to continue to rely on individual ('mum and dad') investors, the current mainstay of the private rental market in Australia. However, while research shows that individual investors are willing to invest in rental housing, Australia's tax provisions for negative gearing<sup>6</sup> mean that most of this investment has been in existing rather than new dwellings, and relatively high value, rather than affordable housing. Further research by Wood and Ong (2010) has found that landlords enticed by negative gearing provisions are more likely to realise their investment and churn properties in and out of the rental market. Obviously, this adversely impacts on tenants, indeed, 25% of tenancies are terminated due to sale, within the first year (ibid, 2010:2).

There are landlords whose mission is to provide long term affordable tenancies: including for-profit and not-for-profit schemes. These landlords have relied on individual investment in conjunction with the Australian Government's new (2008) rental housing financial incentive scheme, known as National Rental Affordability Scheme (NRAS), alongside generous negative gearing provisions permitted to individual investors.

There is a third option: Australia's large financially strong institutional investors, such as superannuation funds, which hold \$1.3 trillion (\$1,300 billion) in funds, a sum anticipated to grow to \$3.2 trillion by 2035. Despite their size and strength, superannuation funds are almost entirely absent from investment in residential property because of a lack of scale (small projects and small landlords) and therefore high management costs, expected low returns combined with high perceived risks, and the absence of an established asset track record on which to base investment decisions. Furthermore, as equity investors, super funds must compete with high marginal tax paying retail investors, who can generate high returns on debt funded investment by virtue of the advantageous way in which their investment (but not that by institutions) is treated by the Australian tax system.<sup>7</sup> Without the benefit of negative gearing and prospect

<sup>4</sup> The estimates are based on combining projections of future need for social and affordable housing with the increases in stock that would be needed to address the estimated current shortfall over a 10 year period (Australian Government 2010: 89). Affordable housing refers to a wider range of low cost housing options provided by non-government agencies using diverse forms of government and private funding.

<sup>5</sup> All values given in the paper are Australian dollars. On May 23rd 2012, AUD\$1 = US\$0.97 and €0.77.

<sup>6</sup> Negative gearing provisions in Australia's tax code, generously support individual investment in rental property. Interest on loans for rental housing and the cost of maintenance and small expenses are deductible and there are also generous provisions for asset depreciation. This led to \$6.5 billion in lost taxation revenue during 2008-2009. [http://www.ato.gov.au/content/downloads/cor00268761\\_2009CH2PER.pdf](http://www.ato.gov.au/content/downloads/cor00268761_2009CH2PER.pdf)

<sup>7</sup> Details of the relative tax treatment of different investments can be found in the Henry Review of the Australian Tax System (The Treasury 2010).



of capital gains, yields on rental property are simply too low and too management intensive for institutional investors' portfolio needs. Later on in this article we return to what Australian investors say would actually entice them to invest in affordable rental housing.

## 6. Financial intermediaries the key

What could bring the two parties together? A financial intermediary can play a critical role. Outside of Australia, many countries with sizeable affordable housing sectors have established special purpose financial intermediaries to channel private funds towards affordable housing providers at the lowest possible cost. By design, these housing finance institutions help to promote national economic stability, moderate the cost of mortgage finance, maintain adequate housing supply and ensure lower income housing needs are met. They work alongside the provision of public loans or grants and targeted tax advantages for affordable and social housing provision. Research on various approaches has informed and catalyzed the development of an Australian proposal. An earlier report by Lawson et al. (2010) examined six specific mechanisms for channeling private investment to affordable housing:

- The French Caisse des Dépôts (CDC), which pools tax-privileged savings and issues low cost loans to housing providers;
- The Swiss bond issuing co-operative for raising finance for housing cooperatives backed by a public guarantee;
- The Austrian Housing Construction Convertible Bonds, as elaborated below;
- The UK mixed public and private financing model for housing associations;
- The US low income housing tax credit scheme (LIHTC), which is used to attract equity investors into low income housing offered by various for-profit and not-for-profit providers; and
- The jointly-funded Dutch government and third sector guarantee fund (Waarborgfonds Sociale Woningbouw - WSW) that operates to reduce the cost of bank finance for housing associations in the Netherlands.

Two mechanisms were examined in detail: housing banks in Austria, that sell tax privileged bonds for limited profit housing development (Deutsch and Lawson, 2010); and The Housing Finance Corporation (THFC) in the UK that operates as a not-for-profit financial intermediary pooling the investment demands of smaller providers of affordable housing (Gilmour et al, 2010).

Specialist financial intermediaries such as these were found to play an effective role pooling the lending demands of smaller providers, applying their specialist knowledge of the sector to strengthen provider's financial capacity and channelling investment towards a variety of suitable projects.

The review of the systems listed above also showed that adequate reassurance can be given to private markets via a combination of public collateral, guarantees, sound financial management and regulation as well as via revenue support (usually in the form of rent assistance). Indeed, a mortgage guarantee on capital market loans provides an alternative to government loans and/or is used to reduce private financing costs by reducing risks to lenders in many European countries, such as Switzerland, France and the Netherlands.

## 7. Austrian approach as a catalyst

Following extensive review, the most appropriate model for an Australian approach, was considered to be the Austrian Housing Construction Convertible Bond (HCCB). There, a competitively allocated public loans and grants system is supplemented by private finance raised through tax privileged housing bonds.<sup>8</sup> The HCCB has been available to retail and institutional investors since 1994. This special purpose private bond, which relies on significant tax incentives to bond purchasers, raises low cost funds for the development of affordable rental housing delivered through the for-profit and limited profit sectors.<sup>9</sup>

HCCB were introduced at a time where there was a high demand for dwellings, yet interest rates were high and unpredictable; there was also a shortage of long-term capital and public loans for limited profit housing associations had been capped. HCCB were designed to broaden the private capital base for funding affordable

housing (Amman and Kratchmann in Lawson et al, 2012:97).

The incentives required for private individuals to invest in long-term assets and the means of providing these were identified as:

- Attractive yield return (achieved through tax concessions).
- Security of capital (achieved by earmarking funds for investment in non-speculative housing and by restricting issuance of housing bonds to publicly supervised banks and registered housing developers).
- Security and stability of interest rates (achieved by issuing fixed rate bonds; variable rate bonds tied to specific indices; or bonds with both nominal and index linked floors and caps on the rates paid).
- Transparency (achieved by explicit legislation defining the characteristics of the bonds and identifying the fiscal measures to support them; and by consumer protection measures for issuing securities).
- Liquidity (achieved by having bonds issued by finance or construction companies listed on the stock exchange).

As a result of the tax concessions provided, today the capital raised is cheaper than alternative long-term capital and refinanced housing loans can be granted at lower interest rates than currently on offer in the market. The cost of raising funds was also kept low by use of existing banks' infrastructure to support the housing banks that were set up as refinancing vehicles within each bank (ibid, 2012:97). The cost to the Austrian government, in terms of lost revenue, has been estimated at €120 million per annum (Deutsch and Lawson, 2010).

HCCB represents one, extremely important, component of the total package used to finance limited profit affordable housing associations in Austria. HCCB provide between 40 per cent and 60 per cent of the finance of new or redeveloped affordable rental housing projects. The bond provides lower cost funds for commercial loans with 20–30 years maturity at 0-30 basis points above the Euribor rate and with a yield that is one per cent lower than the Euribor bond index. When combined with their tax advantages, however, the bond offers an attractive long-term

<sup>8</sup> These financial measures are sometimes complemented by tenant down payments that add to project equity and provide a right-to-buy to tenants on a delayed basis, and often by planning policies and public land agencies that facilitate access to sites for affordable housing projects.

<sup>9</sup> Under Austrian law, the 'profits' of limited profit companies are limited to six per cent and are not distributed but reinvested in the housing activities of the sector (Lawson et al. 2010). Such legislation is currently absent in Australia.

low-risk, ethical form of investment that is widely held in Austria. The HCCB has no government guarantee but is backed by public loans and grants. Additionally, the sound financial position and robust regulation of the limited profit sector gives comfort to investors. Deutsch and Lawson (2010) provide a more detailed case study of the workings of the HCCB in the Austrian market.

### 8. Understanding local conditions

Obviously, housing market and financial conditions in Australia<sup>10</sup> are very different to those found in Austria and elsewhere. Therefore, specialized research and consultation were required to adapt HCCBs to the Australian context. Towards this goal, the research on which this paper is based sought to address four questions:

- What would be appropriate terms and conditions for an Australian Housing Supply Bond, to ensure that it is attractive to investors and raises sufficient low cost funds for borrowers?
- What type of financial intermediary would sell the bonds and how would funds raised be made available for approved projects?
- What type of institutional conditions and regulatory arrangements would ensure funds raised are channeled to the intended purposes?
- What other actions would be required to ensure success of this mechanism?

The research process began with intensive consultation with a wide array of stakeholders in Australia, including institutional investors, regulators, public finance specialists, housing providers and public policy officials. The outcomes of these consultations informed a proposal for a financial intermediary and for a suite of Housing Supply Bonds (HSB) for Australian conditions. This was developed in collaboration with international experts from Austria and with Australian industry partners and was tested in a one-day workshop with expert advisors, stakeholders and academics with relevant expertise. A public seminar provided a wider audience with the opportunity to engage with the visiting international experts, and to ask questions about, and comment on, the emerging outcomes of the project. A more refined proposal was subsequently discussed with Australian policy officials, providing further feedback.

Those consulted emphasised that any financial product designed to support affordable housing supply must be simple and long term. It must recognise that different enhancements are attractive to different market segments. Tax incentives, for example, are more attractive to highly taxed private individuals and government guarantees (or other forms of credit enhancement) are more attractive to larger, long-term investors, such as insurance funds and super funds. A low yield bond enhanced by a tax incentive, therefore, should be designed to attract investment from more highly taxed private individuals and private fund managers. A highly rated but lower yield bond with a government guarantee should be designed to suit the portfolio strategies of large long-term wholesale investors. It is more likely to generate funds at scale if these are sourced from wholesale investors, at least in the first instance (Lawson et al, 2012:62).

Whatever products are developed, risks to investors and the cost of finance will be reduced by a well regulated not-for-profit sector underpinned

by strong business models for providers. When interest and principal are to be borrowed against the revenue stream generated from affordable rental stock (rather than against capital value or asset sales), rent policies, rent assistance and eligibility policies will be critical. Stability of revenue is crucial: thus there needs to be minimal risk of change to rent setting and housing assistance rules (ibid, 2012:62)

The outcomes from consultation around the four research questions are summarised in Table 1.

### 9. An appropriate mechanism for Australia

The feedback received in Australia has informed specific recommendations. The first concerns the establishment of an appropriate specialist financial intermediary. Its role is to link suppliers of capital with appropriate investment opportunities and to create aggre-

**Table 1: Summary of responses by research questions**

<b>Terms and conditions of HSB?</b>	<p>A straight forward, low risk, low yield and long term instrument required to provide cheapest funds</p> <p>Enhancement required to reduce risk and enhance low yield</p> <p>Tax incentives need to be devised so they are equally valuable to those with high and low tax rates</p> <p>Guarantees are very interesting for low risk long term investors - insurance funds, certain portfolios of super funds, banks, retail investors</p>
<b>Financial intermediary?</b>	<p>To pool funds for scale</p> <p>Specialist knowledge of sector</p> <p>SPV to issue bonds, linked to provider loan obligations</p> <p>Optional forms: Public, not-for-profit, for-profit</p>
<b>Regulatory requirements?</b>	<p>Beyond benchmarks, ensure sector regulation meets investor standards</p> <p>Strengthen financial capacity of providers and reduce risks to lenders</p> <p>Use to promote innovation, collaboration and solutions rather than impede growth</p>
<b>Related requirements?</b>	<p>Capacity to repay based on revenue stream</p> <p>Rent assistance and eligibility policy critical</p> <p>Long term and consistent policy vision by governments</p> <p>Facilitative planning and land supply to reduce development risk</p>

Source: Lawson et al. 2012

<sup>10</sup> For a review of supply conditions and the funding of social and affordable housing in Australia, see Lawson et al (2009), Australian Government (2010), Gilmour and Milligan (2012) and Gilmour (2010), and Milligan and Pinnegar (2010) respectively.

gation benefits and efficiencies through lower transaction and search costs. Such an intermediary would possess specialised knowledge of the not-for-profit housing industry and be able to critically assess a recipient's business model and adherence to regulatory requirements. This knowledge would develop further efficiencies by strengthening financial management practices across that sector. An intermediary would be able to pool loan demands and ensure a smooth pipeline of projects and funding. It would provide a credible source of information to investors and providers concerning investment risk and likely returns.

A further role of the financial intermediary could be to assist in making providers 'investment ready'. It would provide access to funds for smaller players, thereby helping to maintain diversity in models of provision and help promote greater competition within the industry. The activities of the intermediary could be limited and steered in such a way as to contribute towards stability in housing and finance systems, such as via appropriate counter cyclical activity, as occurs in Austria. International experience suggests that there are a variety of models for a financial intermediary. Examples are the Guarantee Fund for Social Housing in the Netherlands, The Housing Finance Corporation in the UK and the Housing Banks in Austria.

A second recommendation relates to the marketable terms and conditions for housing bonds that this specialist intermediary would issue. A suite of HSBs is recommended with each bond type having risk and return characteristics and enhancements that are designed to attract different potential investors. The characteristics and enhancements of the proposed three types of HSBs are summarised in Table 2.

As indicated in Table 2, three cost reducing enhancements are proposed matched to each investor segment:

- Government support through the NAHA<sup>11</sup> Growth Fund – via subordinated long term zero interest loans – to provide collateral to underpin bond issues.
- Additional support to fund a contingent liability fund covering the guarantees on AAA Housing Supply Bonds.
- Tax concessions to investors in Tax Smart Housing Supply Bonds.

**Table 2: Target markets for HSB and proposed enhancements**

Bond type	Characteristics & enhancements	Investor segment
AAA Housing Supply Bond	A fixed interest, long term (up to 10 years) AAA-rated bond – implying need for a government guarantee	Super fund managers (15% tax rate)
Tax Smart Housing Supply Bond	A fixed term, fixed interest (or indexed) lower yield long term bond with a tax incentive to generate a competitive after-tax yield	Retail investors (30-48% tax rate)
NAHA Growth Bond	A zero interest bond that converts a direct grant into a long term revolving loan	Governments

Source: Lawson et al. 2012

Whatever form of intermediary is developed, an important condition is that the intermediary, the bonds and the housing providers obtaining loans, are subject to appropriate financial regulation. Such regulation is required to ensure that: the intermediary is appropriately capitalised (or guaranteed); that funds raised by bonds issued are held in trust to ensure they are used for their intended purpose; that housing providers have the requisite management and financial skills; and that investors are aware of the characteristics of the bonds they are purchasing.

A third recommendation concerns a number of specific regulatory measures to reduce risks. These include: ensuring that standards of financial auditing comply with eligibility for funding; a sustainable business model and designated tax privileges. Performance based reporting must be sufficiently robust to ensure adherence to intended goals and appropriate sanctions must be in place to reinforce good performance. Coupled with the drive for national regulation of government assisted housing providers, it is recommended that the national government work towards legislation that sets out the basis of a feasible, efficient and risk reducing business model that would include realistic social policy targets (linked to eligibility for tax privileges). The Austrian approach provides an example of such a form of legislation. In the future, loans, grants and tax privileges could be allocated on a transparent and competitive basis to those operating this non-profit or limited profit business model, driving cross sector development and innovation. Such an approach also enables regional jurisdictions to tailor loan programs (from NAHA growth funds) to suit local agendas such as social inclusion, key worker housing and environmental sustainability.

An overview of the financial architecture required to deliver housing bonds is provided in Figure 1 with the various levels of support provided by government indicated in the dark grey box, affordable housing providers in the central green box, the specialist financial intermediary and the bonds issued indicated in white boxes and the regulatory framework governing this structure in light grey boxes.

## 10. How much will this cost?

HSBs are designed to reduce the cost of funding available for community housing providers below that which is currently available from the private sector and, thereby, to enhance their capacity to increase the supply of affordable housing. However, they cannot generate private finance at a lower rate than would be available if affordable housing was funded directly through government borrowing. The HSB proposal incorporates a combination of public funding (providing direct subsidy) and private bond finance (indirectly subsidised through tax incentives and government guarantees). These are summarised in Figure 2 along with indicative costings. These have been based on interest foregone at 5 per cent per annum for NAHA Growth HSBs; tax foregone at an average 40 per cent income tax rate for Tax Smart HSBs and a 0.5 per cent default rate for the contingent liability fund providing the guarantee for the AAA HSBs. The proportions for each tranche are based on information provided by the industry partner for the research project. They represent a presumed minimum amount required to provide a pseudo-equity underpinning before senior debt is likely to be available and a trade-off between the cost-

<sup>6</sup> This bond type is named NAHA because it proposed that it would form part of Australia's National Affordable Housing Agreement (NAHA) which is the overarching funding, policy and administrative

framework for housing, involving all levels of government. <http://www.fahcsia.gov.au/sa/housing/proserv/affordability/affordablehousing/Pages/default.aspx>

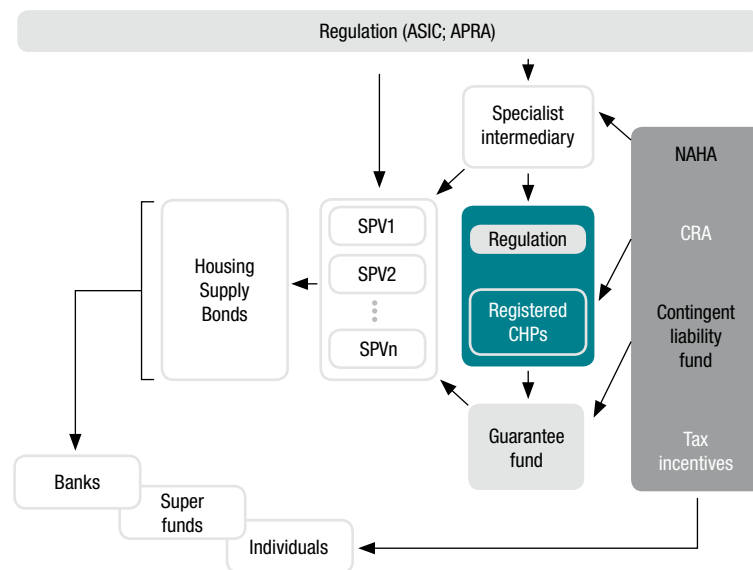
reducing enhancements and the likely yields of the AAA and Tax Smart bonds. The costings presented are based on raising \$7 billion to finance 20,000 dwellings.

HSBs are not intended as a replacement for existing forms of housing assistance for affordable rental housing, such as that provided by rent subsidies (Commonwealth Rent Assistance in Australia), capital grants (NAHA) and tax credits or annual subsidies for additional supply (NRAS).

These indicative costs are based on market conditions that applied towards the end of 2011. They will require more robust evaluation to determine the most appropriate combination of bonds with different enhancements and different trade-offs between yield obtained and cost to government.

The Housing Supply Bonds designed for Australian conditions offer the most developed response so far to multiple calls for reform and innovation in the field of affordable housing investment in Australia. This proposal is now ready for more detailed refinement and development and a strategy has been proposed to progress development.

**Figure 1 The architecture of HSBs**



Acronyms: ASIC: Australian Securities and Investments Commission, APRA: Australia Prudential Regulatory Authority, NAHA: National Affordable Housing Agreement, CRA: Commonwealth Rent Assistance, SPV: Special Purpose Vehicle

Source: Lawson et al. 2012

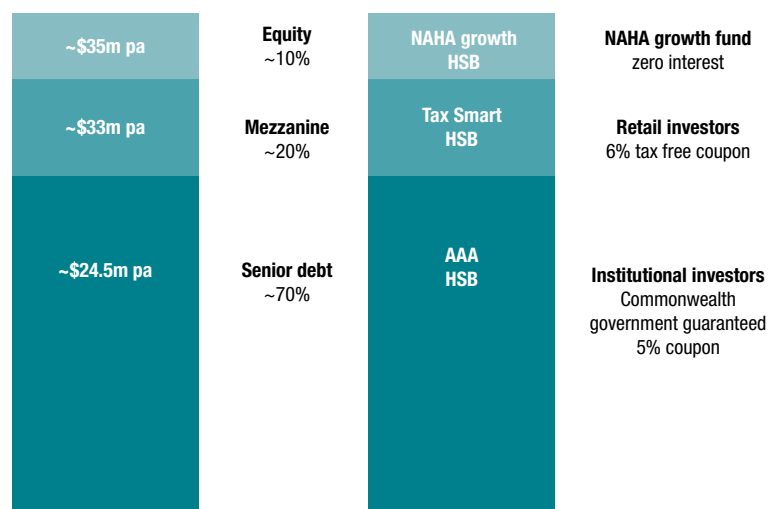
## 11. Onwards!

Overcoming the shortage of affordable rental housing in different national housing systems requires detailed examination of the local regime influencing the flow of investment and pace of development. It also requires intensive consultation and awareness raising amongst key industry stakeholders. However, real change is unlikely without appropriate political commitment and the informed and creative action of public policy makers – particularly those in key financial portfolios. Co-ordinated public and industry efforts directed towards the design of appropriate housing finance instruments and institutions to channel this investment to where it is needed will be crucial.

The Housing Supply Bond proposal outlined in this paper has been stimulated by successful Austrian practice, and tailored through local consultation to overcome a key missing ingredient in Australian housing policy: a financial instrument and intermediary to serve an important segment of the housing market – affordable rental for low income households.

The proposal complements those of recent parliamentary and government-commissioned enquiries that have been concerned with securing the future of Australia's third (social

**Figure 2 Indicative costing of HSB to raise \$7billion**



Source: Lawson et al. 2012

enterprise) sector and enhancing capital investment in that sector. It also comes at a time when the Australian Government is actively encouraging a diversity of funding sources through a deeper and more liquid corporate bond market.

The proposal includes a practical strategy to move from concept to implementation, by drawing further on industry expertise and harnessing and developing capacity within the public sector.



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# BASEL III to deliver a further blow to “financial inclusion” for South African mortgagors

↪ By Pierre Venter<sup>1</sup>

## 1. Basel III in context

The financial crises that plagued North America and Europe in 2008 and the slow recovery of major economies promoted the third revision of the Basel prudential requirements as a response to the crisis. Although aimed primarily at those banks that were affected by the crisis, the new regulations will be enforced globally and they will be applied to relatively smaller localised banks. The imposition of these regulations in some developing countries, whose banking sectors fared relatively well through the crisis, will have a potentially severe impact on the socio-economic growth in such countries.

Basel III is a package of regulations in a series of documents. The first three documents relate to the capital required to be held by banks, where not only the quantum of capital increases but it also impacts on the quality of that capital. Fortunately South African banks are well capitalised and the quality of their capital is also sound. Given the South African context of this article, the author will not dwell on this aspect of Basel III other than to suggest that the majority of globally active and localised banks, in countries outside of South Africa, will be inadequately capitalised, Fitch Ratings suggesting that the world's biggest banks alone may have to raise about \$566 billion to meet the new rules on capital requirements that will be required to be implemented by 2019.

Another document addresses the liquidity of banks, which is the focus of this article. The new liquidity proposals address ‘maturity transformation’. Banks generally fund short, with deposits

repayable on demand or in months, and lend long, with term loans, such as a home loan, repayable in years. The ability for a bank to absorb liquidity shocks is to be addressed through two new parameters, namely the ‘liquidity coverage ratio’, which is required to be implemented by January 2013, and the ‘net stable funding ratio’, which is required to be implemented by January 2018.

The ‘liquidity coverage ratio’ will require banks to hold a portfolio of highly liquid, quality assets, such as government bonds, to meet the net obligations of a bank over a rolling 30 day horizon. The intention is for this new liquidity requirement to provide sufficient time for a bank, the banking regulator and government to determine a course of action during the 30 days, in the event of a “run” against a bank. In South Africa, 60% of total deposits held by banks have a maturity date of less than 30 days. The impact that this new ratio will have on South African banks is therefore significant. Not only will the new strict qualifying asset criteria divert lending away from the economy, but government will also have to issue significant debt to meet the demand, thereby affecting its own financial structures.

The ‘net stable funding’ ratio encourages banks to fund their long-term lending from deposits with a maturity of longer than one year. As previously highlighted, this will be difficult to achieve in South Africa given that 60% of total deposits held by banks are of a short-term nature.

Media articles relating to the expected liquidity squeeze on South African banks and which were based on credible research highlighted that:

- A hypothetical immediate implementation of Basel III in its current form could result in a 75 basis point increase in lending rates and slash economic output by 1.1%;
- Implementing the rules over five years could result in a loss of 0.1%-0.7% of baseline gross domestic product;
- Estimates in respect of the current shortfalls in the South African banking sector to meet the requirements of the ‘liquidity coverage’ and ‘net stable funding’ ratios are calculated to be R240bn and R680bn respectively. Covering such a shortfall from local and international markets will be costly and South African banks will be forced to pass this cost (estimated to be as much as 30%) to borrowers, thus impacting negatively on the demand for credit and affecting growth.

The South African Reserve Bank (SARB) announced that it is to set up a R240 billion “emergency facility” to help major banks in South Africa to meet their Basel III liquidity requirements in mid May 2012, after an 18 month investigation found that the five largest South African banks were only able to meet 68% of their ‘liquidity coverage’ ratio, whilst smaller banks were sufficiently liquid to meet the Basel III requirements without state support.

A follow up media report, highlighted that whilst the SARB is to be applauded for being an early adopter and other jurisdictions are sure to follow suit, such a facility comes at a cost, as a facility drawdown rate equal to the SARB repo rate plus 100 basis points would be charged (6.5%), whilst

<sup>1</sup> Pierre Venter writes in his personal capacity and his views do not necessarily represent those of his employer.



the average cost of funding for major banks is between 3.6% and 4.6%.

The media report further highlights that South Africa’s market will need to be structurally reformed, if the liquidity shortfall is to be addressed, as Fitch Ratings believes that there is not a large enough savings pool from which to draw quality long-term liquidity and local banks are therefore reliant on volatile wholesale funding to finance long-term lending. Fitch Ratings highlights that only 9% of household discretionary savings are being invested in banks. On the other hand households invest 37% of their discretionary savings into pension funds and insurers. In turn, pension funds and insurers place these funds in financial institutions via intermediaries such as professional money managers. It follows that unless there is structural reform, the new Basel III liquidity proposals will pose severe challenges to South African banks and push up their cost of funding substantially. Banks are now faced with having to make a choice between:

- Increasing their long-term deposits;
- Reducing the size of their balance sheets by either selling off non-core assets and/or reducing their long-term lending products, such as home loans (the four major banks in South Africa account for about 96% market share of the mortgage market);
- Re-structuring their lending products portfolio, with increased emphasis on the profitability and time horizon of each term loan type, as well as an increase in unsecured lending;
- Increasing their retail deposits and reducing their reliance on wholesale deposits;
- A combination of the above.

Whilst an in-country banking regulator has an element of national discretion in applying the Basel III rules, the scope for discretion is very limited. The South African Banking Regulator is expected to release details of the application of the Basel III rules in South Africa by the end of 2012.

## 2. Housing demographics and mortgages in context

South Africa never had a sub-prime mortgage market. South African banks are well regulated, well capitalised, conservative and well managed. There wasn’t a single bank which required assistance during the recent global crisis. Whilst the South African banking industry rode through the “global storm” reasonably well, with all banks remaining profitable, they experienced lower

levels of return on equity with higher levels of default than before the crisis, as the South African economy contracted by 6.7%, with over a million formal jobs being lost (total formal jobs in South Africa are about 13.5 million). The recent annual financial results announced by the major banks demonstrate that the industry has turned the corner and the demand for loans is gradually increasing.

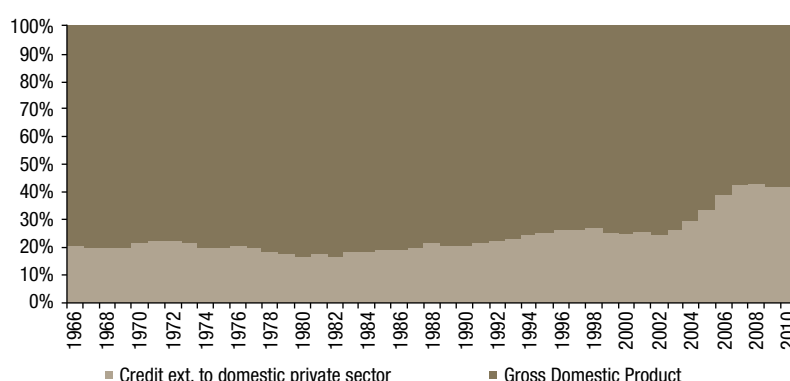
Mortgages account for about 61% of total bank loans. The importance of mortgages as a contributor to national economic growth in South Africa is highlighted by figure 1.

South Africa although classified as a middle income country, has high levels of income inequality and joblessness (the formal unemployment rate is about 25.5% and the gini coefficient is about 0.58), and so the majority of households place reliance on the state for their housing needs (households earning up to R10 000 per month), as is highlighted by figure 2.

In South Africa:

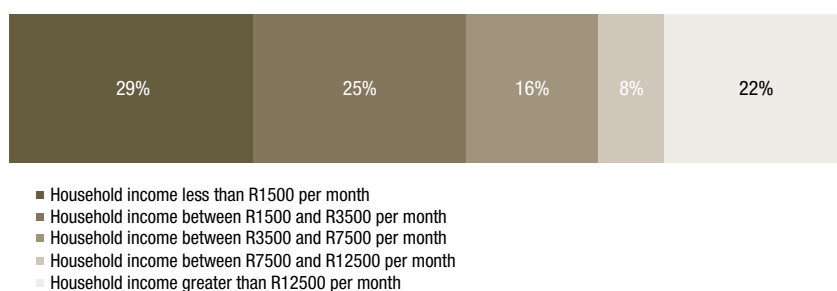
- The state provides a free capital subsidy for homes (40m<sup>2</sup> home on a serviced site) which cost upwards of R200 000 per unit for households earning up to R3 500;
- The cost of a 50m<sup>2</sup> entry level home on a serviced site with slightly better finishes than the free subsidy home is from R300 000 upwards. In order to service such a loan (pre-economic crisis period) a household would need to earn approximately R10 800 per month;
- There was therefore an “affordability gap in the property ladder” for households earning between R3 501 and R10 800, such families earning too much to qualify for a free home but too poor to qualify for an entry level mortgage. This “affordability gap” was to a limited degree filled partly by a state capital subsidy and the balance by way of a mortgage bond. This subsidy scheme has recently been reviewed to make it more effective.

**Figure 1 Total Mortgage loan book as % of GDP**



Source: South African Reserve Bank, Quarterly Bulletin, 2011

**Figure 2 Households by income**



Source: Statistics South Africa, General Household Survey, 2009

## BASEL III to deliver a further blow to “financial inclusion” for South African mortgagors

**Table 1: Household income demographics in South Africa**

MONTHLY HOUSEHOLD INCOME	R0 - R3,500	R3,501 - R7,000	R 7,001 - R 10,000	R 10,001 - R 15,000	R 15,001 - R 20,000	R 20,000 +	TOTAL (000's)
<b>(000's) FORMAL</b>							
<b>Owned</b>	2 596 (21%)	881 (6%)	415 (3%)	523 (4%)	309 (3%)	1 026 (9%)	<b>5 750 (46%)</b>
<b>Rented</b>	1 381 (11%)	433 (4%)	224 (2%)	229 (2%)	103 (1%)	256 (2%)	<b>2 626 (22%)</b>
<b>INFORMAL</b>							
<b>Urban</b>	1 529 (12%)	358 (3%)	132 (1%)	65 (1%)	24 (0%)	40 (0%)	<b>2 148 (17%)</b>
<b>Rural etc.</b>	54	16	14	7	54	16	<b>14</b>
<b>Total</b>	<b>6 854 (55%)</b>	<b>2 001 (16%)</b>	<b>867 (7%)</b>	<b>846 (7%)</b>	<b>457 (4%)</b>	<b>1 354 (11%)</b>	<b>2 379 (100%)</b>

Source: Department of human settlements

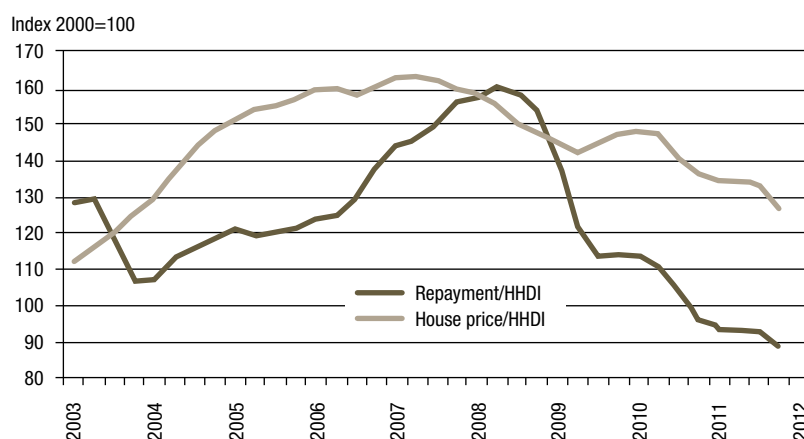
The above table highlights that the state was/is responsible for addressing the needs of approximately 71% of the urban population (household income up to R7 000 per month), with partial assistance for a further 7% being required (household income between R7 001 and R10 000 per month, the so called “affordability gap” market). Whilst over 3 million state subsidy units have been delivered since 1994, urban housing backlogs still total approximately 2,1 million units within the pure subsidy market segment, with a further “affordability gap” market housing backlog of approximately 250 000 units (pre economic crisis period).

For the 8 year period prior to the economic crisis, the average annual growth in property prices was 16%. Since then the average annual property price growth has been a mere 3% (consumer price inflation currently 6%). Leading up to 2008, lenders lent aggressively to the housing market in the belief that house prices would continue to increase well ahead of inflation levels and so they under-priced default and losses given default risks. However, the economic and employment downturn due to the global crisis resulted in impairments increasing to about 6%<sup>1</sup>, with a resultant increase in loan losses. This reduced the return on equity (ROE) on mortgage portfolios to approximately 4% in 2008<sup>1</sup>, but new loans granted since then are estimated to yield a ROE of 22%<sup>1</sup>, with mortgagees focussing on quality origination and improved margins (for the “affordable” housing market segment, including the “affordability gap” sub-market segment, interest rates have increased by approximately 2% from the average of the prime overdraft interest rate). On average, overall mortgage portfolios are providing mortgagees with a ROE of approximately 13%<sup>1</sup>, which is fairly low when compared with many other lending products. It is therefore not surprising that the overall growth in mortgage balances has only been 2,2% over

the past year, whilst the growth in balances of shorter tenure, more profitable lending products, such as personal loans, has increased by 57%

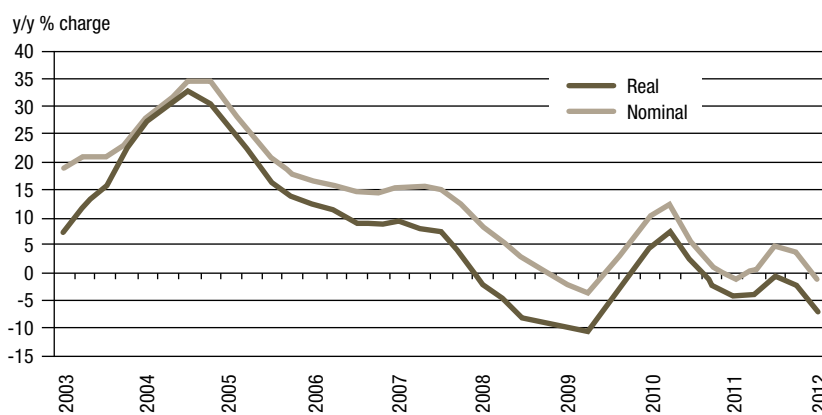
(off a small base, as this currently only equates to about 8% of the sector's overall asset base). Lack of affordability at existing price levels, (see

**Figure 3 Affordability of housing**



Source: ABSA Bank

**Figure 4 House price growth (80m<sup>2</sup> - 400m<sup>2</sup>, ≤ R3.6 million)**



Source: ABSA Bank

figure 3) supports the view of leading property economists that residential property prices will continue to deflate in real terms for some years to come (also see house price growth figure).

This outlook does not bode well for financial inclusion as interest rate increases have a material impact on affordability levels (see table 2).

The author submits that the adverse impact on financial inclusion due to a combination of the slowdown in consumer demand in an uncertain economic climate, coupled with high consumer debt to income levels (approximately 75%), impaired consumer track records (approximately 46%) and a reluctance by mortgagees to return to their pre-crisis aggressive lending standards to achieve asset growth, has denied approximately 100 000 first time home buyers the opportunity of being able to acquire their own homes. Furthermore, if the liquidity impact of Basel III will be to increase a mortgagee's cost of funding by approximately 30% as is suggested, the author believes that this will have a direct negative affordability impact on about another 150 000 such families.

## 3. Conclusion

In conclusion, the global economic crisis coupled with the negative affordability impact that Basel III will introduce, will probably double housing backlogs within the “affordability gap” market segment in South Africa from approximately 250 000 units to 500 000 units.

**Table 2: Affordability - 50m<sup>2</sup> Entry Level Home (Cost: R 300 000)**

INTEREST RATE	REPAYMENTS (20 Years)	REQUIRED HOUSEHOLD INCOME
<b>PRIME</b> (RATE CHARGED PRE CRISIS)	R 2 700 Per Month	R 10 800 Per Month
<b>PRIME + 2%</b> (RATE CHARGED POST CRISIS)	R 3 097 Per Month	R 12 388 Per Month
<b>PRIME + 4.7%</b> (RATE TO BE CHARGED POST BASEL III IMPLEMENTATION?)	R 3 665 Per Month	R 14 660 Per Month

Whilst Basel III represents a fundamental shift in addressing the failure of the financial markets and is likely to make banks more resilient and stronger in the long term, this will come at a cost to financial inclusion, global annual economic growth (estimated to be 0.15% by the Organisation for Economic Cooperation and Development) and in developing countries their socio-economic imperatives which include economic growth, job creation and financial inclusion.

Given the dynamics of a competitive market, one can however expect to see innovation, which will allow mortgagees to develop approaches to do business in the restrictive environment. This could possibly take the form of a resurgence of securitisation, the introduction of a private sector owned liquidity fund or the introduction of covered bonds, with banks amending their operating model to that of being originators and warehousing mortgages, which are subsequently transferred to investors (primarily pension funds and insurers).

There is real cause for concern that in solving global bank prudential problems, the implementation of Basel III within South Africa will stifle economic growth (currently at about 3%, with 6% levels required if joblessness is to be addressed) and at the same time it will increase the levels of financial exclusion in a country which already has one of the highest gini coefficient's in the world.

On a positive note, a more recent media article quotes Charles Freeland, former deputy secretary-general of the Basel Committee on Banking Supervision, as stating that “the Basel regulators are considering relaxing the liquidity requirements without watering down their broader objective, whilst in-country regulators will have a degree of discretion during the phased implementation of the rules. Some of the regulators will be able to get away with some concessionary treatment of some of their banks and South Africa will be in a position, if they want to, to have some softer regulations for some of their banks”.

# Sustainable housing finance – an approach to get housing finance back on track<sup>1</sup>

↪ By Mark Weinrich and Juri Schudrowitz

## 1. Introduction

The financial crisis, which started in 2006, and whose consequences are still lingering and threatening global economic recovery, has been the subject of broad academic research in the last couple of years. Agreement about the crisis' causes is quite robust: misleading incentives in housing policies in many countries, flaws in housing finance, and corporate as well as individual behaviour have played a large part in the

collapse of housing markets. Research has also shed some light on the role of housing markets in different economies – in industrialised countries, emerging economies and developing countries. There is virtually no economy where housing does not play an important role in domestic demand, growth and prosperity. This is also true for the social dimensions of living in one's own four walls, as well as for ecological goals, such as the reduction of carbon-dioxide-emissions and energy consumption (Putnam, 2000).

To keep housing markets going and to reinvigorate them in the aftermath of the financial crisis remains a key task (Bailey, 2011). Given the specific role of housing finance in relation to economic performance, it is imperative to analyse concepts of housing finance in order to reduce volatility and to create more stability.

## 2. Concepts of sustainability and sustainability of housing finance

Figure 1: Dimensions of sustainable housing finance

<b>Ecological Sustainability</b>	Does the source of housing funding contribute to the reduction of greenhouse emissions and does it enhance resource efficiency?
<b>Economic Sustainability</b>	Is the system of housing finance able to persist over the long term?
	Is it resilient to external shocks?
	Does the system contribute to economic stability?
<b>Social Sustainability</b>	Does the system of housing finance allow a high proportion of people from all social backgrounds to become home-owners?
	Is the design of housing finance likely to avoid overstraining the home-owner's financial resources?
<b>Fiscal Sustainability</b>	Is government support of home-ownership efficient in the long-run?
	Does the government's policy contribute to a reduction of bubbles?
	And does it help to avoid the socialisation of private losses?
	Is the set of rules for housing finance adequate to promote the aforementioned goals?

With an ever increasing awareness of sustainability and its growing impact on policies, the sheer number of definitions has increased and as debates about the most suited definition have gained momentum, controversies about its scope and purpose have been heated. However, most definitions can be reduced to a common core: a given quantity or object has to be maintained in its current status to allow current and future generations to benefit from it. Thus access to resources or adequate substitutes has to be guaranteed over a (virtually unlimited) time span. Apart from these core elements, four dimensions of sustainability appear to be generally accepted: ecological, social and economic as well as fiscal.

Definitions of sustainable housing finance have so far been scarce, although the awareness of sustainability in housing finance has increased significantly (OECD, 2005). Existing – but not established – definitions have a strong focus on social aspects, somewhat losing sight of other dimensions of sustainability and their interconnections.

<sup>1</sup> This article is an excerpt from a discussion paper prepared by the Association of Private German Bausparkassen.



Taking into account the four dimensions of sustainability (Fig. 1) and the previous literature on sustainable housing finance, the requirement for sustainable housing finance is met under the following condition (thus giving a preliminary yet robust definition of sustainable housing finance): a stable set of rules enables a large share of the population to fund residential property within an adequate period of time on transparent terms and predictable as well as affordable cash flows, thus creating stable housing markets with a minimum risk of private/corporate failure and public involvement, while slashing the emission of greenhouse gases.

## 3. Types of housing finance

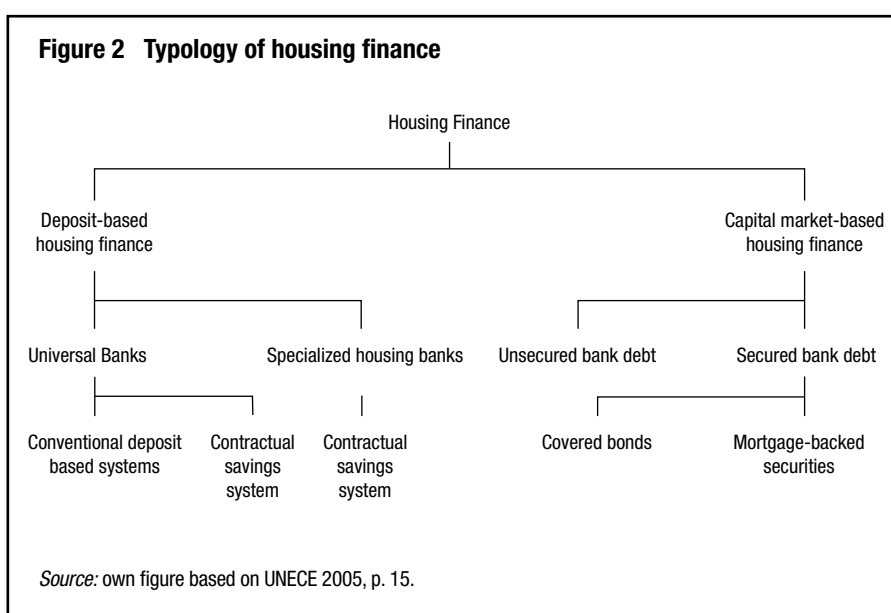
A reasonable typology of housing finance can be derived from the different channels of funding on the supply side as it was conducted by the United Nations Economic Commission for Europe (UNECE) in 2005. This typology has been refined and modified for this study.

### 3.1 Deposit based housing finance

In most parts of Europe and many other parts of the world, deposit finance can be considered as the traditional and long-standing way to finance the purchase or construction of homes (Bol  at, 1985). Generally speaking, financial intermediaries pool their customers' savings deposits and hand them out as loans to other customers (UNECE, 1998) – this can take place in the form of the conventional deposit based system or as contractual savings scheme.

#### 3.1.1 Conventional deposit based systems

The use of conventional deposits is an important, available and usually relatively cheap source for funding (Haldrup, 2010). This form of funding is a claim on the bank's balance sheet as a whole. In many countries, insurance or guarantees provide protection up to some level but any deposit larger than that is a form of unsecured funding. The major challenge for a conventional deposit-based housing finance system is an adequate maturity transformation. Usually, deposits are only of short maturity, while housing finance is a long-term investment. This fact creates liquidity risk for lenders providing long-term mortgages. In order to avoid the interest rate



risk, lenders can offer adjustable rate mortgages, exposing borrowers to interest rate risk. By using conventional deposits for housing finance usually both lenders and borrowers have to bear considerable liquidity and interest rate risk. Though in general deposits are a cheap source of housing finance, this does not need to be so in all cases. If savings on bank deposits are a scarce source for funding because the demand for housing finance is high, interest rates on deposits might be high, decreasing the affordability of loans. The same applies for countries with a less stable macroeconomic environment or limited trust in the banking system. Here, savers might ask for high interest rates on deposits in order to put their money in the banking system. Furthermore, deposits are not a cost-effective way to raise funding at short notice.

#### 3.1.2 Contractual savings schemes

The basic idea of a contractual savings system for housing is as follows:<sup>2</sup> The contract comprises a period of saving and the commitment of the lender to grant a loan after the successful completion of the savings scheme. The contract determines the contract amount, savings rate and interest rates – this means that the interest rate of the loan (and on the deposit) is predetermined at the contract stage for the whole duration (D  bel, 2009).<sup>3</sup> Loans are disbursed solely to previous savers and contractors.

In the contractual savings system loans are only funded by means of mutual savings and loan repayments. It is thus independent of the capital market, yet it is not completely resilient to liquidity problems for it relies on the continuous acquisition of new savers (Yasui, 2002). In order to ensure that new loans can be funded out of the contractual savings institution's current cash flow (new savings plus loan repayments) loans are disbursed according to a complex allocation process. The contractual savings institutions are usually subject to both banking regulation as well as a specific legislative act on these institutions. This specific act usually contains a set of rules for the specific customer-relationship, ring-fences the specialised credit institutions and grants them the only authority to provide contractual savings schemes (UNECE, 2005).

### 3.2. Capital market based housing finance

Lenders can tap the capital markets through unsecured and secured debt. While secured debt is collateralised with a lien this is not the case for unsecured debt.

#### 3.2.1 Unsecured debt

Unsecured debt is an important source of funding for credit institutions (Debelle, 2011). This form

<sup>2</sup> The system is known as the "open" *  pargne logement* in France and as the "closed" Bausparen in Germany and Austria (D  bel, 2009). In the latter countries it is a major source of housing finance and has now been established in many countries of Eastern Europe. It is also popular in other regions and is experiencing a renaissance in China right now. Only contractual savings schemes offered by specialised credit institutions are discussed in this paper.

<sup>3</sup> This applies only to the "closed" variant of contractual savings for housing systems. In the "open" variant interest rates are not predetermined from the outset as funding can come also from other sources than the collective. In the following, only the "closed" system is discussed.

of funding is a claim on the bank's balance sheet as a whole. The stronger institutions with good credit ratings have generally had ready access to unsecured funding even following the onset of the financial crisis, but a number of institutions have been shut out of unsecured markets. Unsecured debt will in general pay a higher yield than secured debt as the credit exposure is higher. However, that does not necessarily mean that unsecured debt is a more expensive funding instrument than secured debt as the credit enhancement of the latter also comes at a cost. Unsecured debt instruments have different maturity periods ranging from a few days to several years.

### 3.2.2 Secured debt

By issuing secured debt, credit institutions meet the demand for loans by selling covered bonds to private and institutional investors, or by issuing mortgage-backed securities.

At a very basic level, mortgage-backed securities and covered bonds work similarly. Credit institutions originate mortgages that are then put by the same or a different institution into a 'ring-fenced' pool. While the characteristics of the ring fencing and the pool can differ across type of securities and across countries, the common characteristics are that the mortgages serve as specific collateral for the bonds, be they mortgage-backed securities or covered bonds.

#### 3.2.2.1 Covered bonds

Covered bonds<sup>4</sup> are debt securities that are backed by a pool of mortgages and offer the holder what is known as a dual recourse: they are backed by mortgages on the bank's balance sheet, as well as by the solvency of the bank itself. A credit institution creates a mortgage pool by designating mortgages that it originated itself or that it bought from other banks as part of the pool. This process is known as ring-fencing. Then the credit institution issues bonds collateralised by the pool. The face value of mortgages in the pool almost always exceeds the value of the bonds (over-collateralisation). Thus, while the interest and principal on a covered bond may be paid out of the issuing bank's general funds, the ring-fenced pool is there to repay the bondholders if the issuer becomes insolvent. Conversely, if the cover pool proves inadequate

the creditor can claim against other assets of the issuing credit institution. Therefore, the rating of covered bonds is usually higher than the one of the issuing bank (the large majority of covered bonds have an AAA rating).

One other important feature of covered bonds is that if a mortgage in the covered bond pool defaults or is repaid early, the bank replaces the loan with a new mortgage – the pool size is maintained. Hence, the issuing bank bears the credit risk of the mortgages. Covered bonds comprise a high level of security for the creditor because they are tied to a physical value and are in many countries subject to a specific regulation, including limits to the loan-to-value ratio and strict requirements concerning the cover and matching principle – thus playing a major role in funding mortgage credits (UNECE, 2005). Despite the more or less strict regulation and the collateralisation, covered bonds are not immune to the volatility and external effects of the capital market as the Danish experience has shown (Gyntelberg et al., 2011).

#### 3.2.2.2 Mortgage-backed securities

Mortgage-backed securities follow the principle of pooling debt as well, i.e. mortgage loans or mortgage bonds are pooled and then passed on to the capital market as mortgage-backed securities – this process is known as securitisation. In this process, the securitising organisation sells the mortgages (that it bought or originated itself) to a shell corporation it sets up, typically known as special purpose vehicle (SPV). The SPV issues mortgage-backed securities and uses the revenues from selling the bonds to pay for the mortgages it has purchased. The SPV uses the principal and interest paid on the mortgages to repay the bondholders. As the SPV is set up as a separate corporate entity mortgage-backed securities are not an on-balance sheet claim but bondholders are given legal protection if the issuing bank becomes insolvent. This is the major difference in comparison to covered bonds: Assets are removed from the balance sheet of the originating institution (off-balance sheet securitisation) and all risks (market, prepayment, credit) are transferred from the originator/issuer to the investor. As the pool of mortgages backing a mortgage-backed securities issue is static (defaulted or early repaid mortgages are not replaced by the bank), the bonds in an issue

are usually split into tranches for credit enhancement. This use of tranches allows bonds to differ in credit risk, yield and also the maturity. These special characteristics of mortgage-backed securities enable banks to also pool riskier mortgages than is the case for covered bonds.

The issuance of mortgage-backed securities usually involves the development of new players, such as servicers and securities packagers – the mortgage process is separated by role or "unbundled". It also requires a specific regulation to enhance the sound operation of the market for housing finance and an institutional framework as does any other sub-market in the financial market. The practice of securitisation has also led to the creation of more sophisticated financial products such as collateralised mortgage obligations and different asset classes with different risks and yields. As securitisation usually involves a large number of players this might cause friction and makes the proper management of risks difficult and reduces their transparency – literally speaking – to a state of opaqueness (Ashcraft and Schuermann, 2008). The complex process, as well as the significant fixed costs in setting up an SPV and of underwriting the bonds issued by the SPV, has made it in many cases necessary that a government agency or a government-sponsored agency be required to jump-start and/or support the market. In the United States, the combination of an overwhelming political goal of "affordable housing", the role of the government-sponsored enterprises "Fannie Mae" and "Freddie Mac", the recession in the US housing market culminating in and 2007 as well as the emergence of highly correlated risks were key elements in the past financial crisis.<sup>5</sup>

## 4. Sustainability and housing finance – an assessment

The different types of housing finance are now compared against the backdrop of the definition of sustainable housing finance given above. Special attention is paid to the economic, social, fiscal and ecological sustainability of every particular system as well as to the affordability of loans under each regime.

### 4.1 Conventional deposits

The *economic and social sustainability* of conventional deposit-based housing finance

<sup>4</sup> While each country has its own definition of what constitutes a "covered bond", there are several basic common features that allows for branding them "covered bond". Covered bonds are deeply rooted in Germany and Denmark, the countries with the longest covered bond histories. Their covered bond types, the German *Pfandbrief* and till 2008 the Danish *Realkreditobligationer* (now *Særligt Dækkede*

*Obligationer*), provide a good example of the various ways the product can evolve. Whether structured covered bonds (issued e.g. in the UK) belong to the product family needs further discussion.

<sup>5</sup> For an in-depth analysis of the financial crisis and the role of housing finance see the report to the United States Senate, Levin (2011).

systems is only mediocre: The liquidity and interest rate risk due to the maturity mismatch is usually substantial for the lender, so that external shocks (e.g. rising inflation rates) threaten the existence of the system. The lenders have the possibility of reducing their risks by offering either fixed-interest loans with only a short duration or adjustable rate mortgages. This, in turn, exposes the borrowers to interest rate risks creating a danger that the home-owner's financial resources will become overstrained and the mortgage will end up in default. Usually, the banks try to reduce this credit risk by offering only moderate/ low price-to-income and loan-to-value ratios. However, low price-to-income and loan-to-value ratios reduce the opportunities for many people to become homeowners quickly.

Deposits are often a cheap and readily available source of housing finance, which is good for the affordability of housing. However, as discussed above, this is not always the case and depends on the overall macroeconomic environment.

The *fiscal sustainability* of a deposit-based system is also questionable. If a deposit insurance or guarantee exists that enjoys an implicit or explicit government guarantee, the burden for the taxpayer in times of crisis might be very high.<sup>6</sup>

In terms of the *ecological sustainability*, deposit-based housing finance is neutral. For the renovation or modernisation of an existing house an owner-occupier usually only needs a small loan. A deposit-based housing finance system should be able to offer loans of small amounts without a high surcharge.

## 4.2 Contractual savings schemes

The structure of the contractual savings system offers several advantages over conventional deposit-based housing finance. It therefore provides a good source of sustainable housing finance in all aspects.

First, as savers have to save at least for a minimum time period before they can receive a loan, the contractual savings system offers a sustainable source of long-term funds. The maturity mismatch so prominent in the conventional deposit-based system is highly reduced. Furthermore, as the system is independent of

the capital markets and the interest rates fixed at the conclusion of the contract there is no interest rate risk for lenders or borrowers. Liquidity risk is only marginal as loans are disbursed according to a complex allocation process in order to ensure that new loans can be funded out of the contractual savings institution's current cash flow (new savings plus loan repayments). The *economic sustainability* is therefore very good as the system is resilient to external shocks, and it has proven persistent over the long term. Only an inflation rate in the double digits might pose a serious challenge to the system.

A system based on an obligatory savings period means that the borrowers have proved their ability to save, and when they have equity at stake in the property, there are inbuilt incentives for borrowers to honor their obligations. The mechanism thus serves as a screening process for creditworthiness. The saved up equity also serves as a risk buffer for the borrower: the borrower needs less credit, is therefore less indebted, and can repay the loan faster. Moreover, lenders are protected in case of default through the equity of borrowers. This has also been proven by empirical evidence: in all countries members of a contractual savings scheme have considerably lower default rates than normal mortgagees. This fact contributes not only to the economic sustainability, but it also means that the system supports homeowners in a considerable way, so that they do not overstrain their financial resources.

The affordability of these loans is enhanced as the loan is provided at credit conditions usually more favorable than market conditions and because fees are low. The contractual savings system is usually able to offer higher loan-to-value ratios on a solid reference value than other housing finance instruments. The scheme is attractive for low- and middle-income earners, especially if the government gives savings incentives targeted by income.

The downside is that borrowers need time to generate prior savings and that the redemption time for credit from contractual savings institutions is usually relatively short. Moreover, these loans are normally of only a modest size so that they need to be supplemented with other sources of housing finance.

In terms of the *ecological sustainability* the system is good, as small loan amounts (that are perfectly suited for the modernisation or renovation of owner-occupied property) are the rule, not the exception. The favourable conditions of a contractual savings loan are therefore also available for modernisations loans. The borrower also saves fees, as the contractual savings institutions do not usually ask for a land charge in the cadaster for modernisation loans.

The contractual savings system is also sustainable in fiscal terms. The special architecture of a system that is built around safety makes it very unlikely that the government would need to come to the rescue. In this case government subsidies support savings, not debt and therefore pose a better incentive in the efficient allocation of resources.

## 4.3 Unsecured debt

As unsecured debt instruments have different maturity periods, the maturity mismatch in regard to long-term investments like housing finance is reduced. Interest rate risk and liquidity risk are therefore reduced to a moderate level for the credit institutions. Nevertheless, the current crisis has shown that this type of funding is easily negatively affected by external shocks and the general volatilities of capital markets. Unsecured debt is therefore moderate in terms of social and *economic sustainability*.

By using unsecured debt, at least the strong credit institutions will be able to offer competitively priced housing loans. This might not be the case for weaker banks. As unsecured debt enables banks to also offer fixed-interest rate loans with longer duration and without having to bear too much interest rate and liquidity risk, borrowers can choose housing finance products that do not expose them to interest rate risk. This helps the borrowers not to overstrain their financial resources. As this reduces the credit risk, banks are also able to offer higher loan-to-value-ratios and price-to-income ratios than in the case of conventional deposit-based housing finance – but not as high as in the contractual savings system.

The *fiscal sustainability* of unsecured debt might be a severe problem. As the biggest investors in bank bonds/unsecured bank debt are insti-

<sup>6</sup> Examples of conventional deposit based housing finance systems that caused high fiscal costs and showed a poor economic sustainability are the crisis of the savings and loans associations in the United States in the 1980s and the 1990s and the problems of the Spanish savings banks (cajas) in the current crisis. Many more examples could be added.



tutional investors like insurance companies, the government could not allow a major default in unsecured bank debt without threatening the collapse of the whole financial sector.

In terms of the *ecological sustainability*, funding with unsecured debt is neutral. For the renovation or modernisation of an existing house an owner-occupier usually only needs a small loan. By using unsecured debt, at least the strong banks should be able to offer loans of small amounts without a high surcharge.

### 4.4 Covered bonds

The *economic and social sustainability* of covered bonds is good. Covered bonds greatly reduce the maturity mismatch. Interest rate risk and liquidity risk are therefore reduced to a very moderate level for the credit institutions. Empirical studies have shown that covered bonds are able to enhance the liquidity situation of a bank. However, by accessing the capital market the dependence on the respective conditions which do not necessarily reflect the basic conditions in the housing finance market rise in general. This was also the case in the wake of the financial crisis when spreads on covered bonds rose and the issuance of new bonds in the primary market almost came to a halt.

Although the security structure of covered bonds comes at a price, the low yields that bond investors usually demand enable banks to offer attractively priced fixed-interest mortgage loans to borrowers. This also helps the borrowers not to overstrain their financial resources as they are protected from interest rate risk. However, national covered bond laws usually prescribe a maximum of 60% to 80% loan-to-value. Therefore, without supplementary housing finance households will be not able to become home-owners quickly.

The *fiscal sustainability* of covered bonds might be a problem. The covered bond market was not totally immune to the effects of the crisis (Beirne et al., 2011). Spreads in the secondary market widened and issuance stalled in the primary market. In addition, secondary market liquidity deteriorated. Therefore, the European Central Bank decided to make outright purchases of covered bonds to the nominal value of €60 billion. It is therefore possible that a loss for the taxpayer would occur if covered bonds failed. This has not been the case so far, but governments have also been reluctant to put the security structure of covered bonds to the test.

In terms of *ecological sustainability*, funding with covered bonds would not be the first choice.

Evidently, it is more cost-efficient to pool large mortgage loans than small ones. An owner-occupier usually needs only a small loan for the renovation or modernisation of an existing house. If the bank is funding such modernisation loans with covered bonds it will have to ask for a “small loan surcharge”.

### 4.5 Mortgage-backed securities

The economic sustainability of mortgage-backed securities is only moderate, but they are good in relation to some aspects of social sustainability. The fiscal sustainability is moderate to negative – this depends especially on the role government-sponsored or government-backed enterprises play in the securitisation process. Like covered bonds mortgage-backed securities do not really support *ecological sustainability*.

Mortgage backed securities almost eradicate the maturity mismatch. Interest rate risk and liquidity risk are therefore reduced to an extremely low or even non-existent level for the credit institutions. As the issuer passes on the credit risk to the investor, the bank can also eliminate its credit risk (though issuers in some countries keep “skin in the game”). However, by accessing the capital market the dependence on factors which do not necessarily reflect the basic conditions in the housing finance market rise in general. This was also the case in the financial crisis when investors virtually stopped buying any mortgage-backed securities. The financial crisis has also shown that credit institutions continued to hold a large share of the issued mortgage-backed securities so that they were circulating the risk rather than dispersing it. This behaviour annuls the basic idea and one major advantage of mortgage-backed securities. Furthermore, the process of creating mortgage-backed securities is complex, opaque, and implies significant fixed costs. This makes moral hazard a problem, especially if all credit risk is transferred to the investors (originate-to-distribute model). As it is difficult and expensive for investors to examine the credit risk of each mortgage in a pool, banks have an incentive to place higher-risk mortgages in a pool than investors may be aware of. This poses a threat to the stability of the whole financial system if the securities are mainly held by institutional investors like pension funds and insurance companies. Some countries have approached this problem by creating government-sponsored agencies or government agencies that guarantee investors the timely payment of principal and interest on mortgage-backed securities. However, this arrangement threatens the *fiscal sustainability*.

Funding with mortgage-backed securities allows the credit institutions to offer competi-

tively priced fixed-interest mortgage loans to borrowers. Therefore, loans are affordable and borrowers are protected from interest-rate risk. This helps people to not overstrain their financial resources. The special structure of mortgage-backed securities also enables banks to offer high loan-to-value and price-to-income ratios – even to borrowers with a battered credit score. This helps people from wide social backgrounds to become home-owners quickly. However, this is a double edged advantage – especially if banks adhere to the “originate-to-distribute-model” and do not check the credit risk thoroughly. It gives rise to fraudulent lending so that people get loans that they will not be able to pay back. Therefore, the moral hazard problem may not only hit investors but also the borrowers that are lured into (unaffordable) home-ownership.

When there are only private-label mortgage backed securities issuers, the fiscal sustainability of mortgage-backed securities is comparable to covered bonds. This changes drastically with the involvement of government-sponsored agencies or government agencies that guarantee investors the timely payment of principal and interest on mortgage-backed securities. If mortgage-backed securities are backed with an implicit or explicit government guarantee, the risk and costs for the taxpayer are enormous. The financial collapse of Fannie Mae and Freddie Mac (the major mortgage securitisers) in 2008 in the United States stands out as just such a negative example.

The *ecological sustainability* of mortgage-backed securities is quite similar to covered bonds. The nature of energy-efficient modernisation only calls for small scale loans. Thus the need to levy a small surcharge is more likely but this drives up costs for home-owners.

## 5. Conclusion

Enabling a large number of citizens to live in their own property has been a long standing issue in many economies, both small and large, be they industrialised or economies in transition. Housing is a key factor for the development of sustainable societies. Sustainable housing finance is a necessary prerequisite to living in one's own residential property. This calls, above all, for stable macro-economic conditions, such as the absence of high rates of unemployment and inflation, reliability in economic policy and the presence of enforceable property rights.

In this paper we have made a first attempt at defining sustainable housing finance, developing different criteria of sustainability in this field and



applying it to different dimensions of housing finance. Our main results can be outlined, in a rough sketch, as follows:

Sustainability in housing finance cannot be achieved through one single channel of funding. It is necessary rather to finance the purchase through a set of different channels to meet the needs of borrowers and lenders properly. Furthermore, at various points in time, some markets are more functional than others.

In many cases conventional deposits are and will continue to be the backbone of housing finance as they are usually an available and relatively cheap source of funding – although conventional deposits do not excel in terms of sustainability. It is therefore appropriate to accompany this source with other sources of housing finance. In times of crisis, there is a clear preference on the part of investors for secured investments. However, this gives rise to the concern that in a world where the only source of funding available is secured, it is also simply unsustainable. This is so because all of the forms of funding are claims on a bank's balance sheet in one form or another; the underlying assets aren't that much different, rather the difference is in the degree of credit enhancement provided by subordination (mortgage-backed securities) or over-collateralisation (covered bonds). The major rationale for investors to choose secured debt is to reposition themselves towards the front of the creditor queue; that is the substantial differentiation between the various forms of funding. But clearly, not everyone can be at the front of the queue.

From the perspective of sustainability, a purchase entirely with debt does not provide the right incentives. The inclusion of equity is a form of self-commitment and forms a risk buffer. Contractual savings schemes are a form of self-imposed rule and auto-discipline, for they link the granting of a loan to a previous period of saving. The acquisition of a home is usually the single most important and most expensive investment an individual will ever make. Transparency and predictability over a longer period of time are thus pivotal and indispensable for sustainability. The return of the collateral value as a key figure in housing finance and lending is a first step in the right direction.

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# Investment in housing: demand versus supply side subsidies – conclusion of the debate

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The debate begun in the Spring 2012 HFI continues in this edition with two new contributors. Rob Van Hoofstat and Rudy de Jong take the two sides of the case in turn.

# Demand side subsidies can boost supply in a more efficient way

↪ By Rob Van Hoofstat

This topic is often the subject of debate between the private sector and the (semi-)public social housing sector. To ensure a level playing field and provider neutrality the private sector is more in favor of demand side subsidies. The social housing sector is pro supply side subsidies that go directly to the social housing sector.

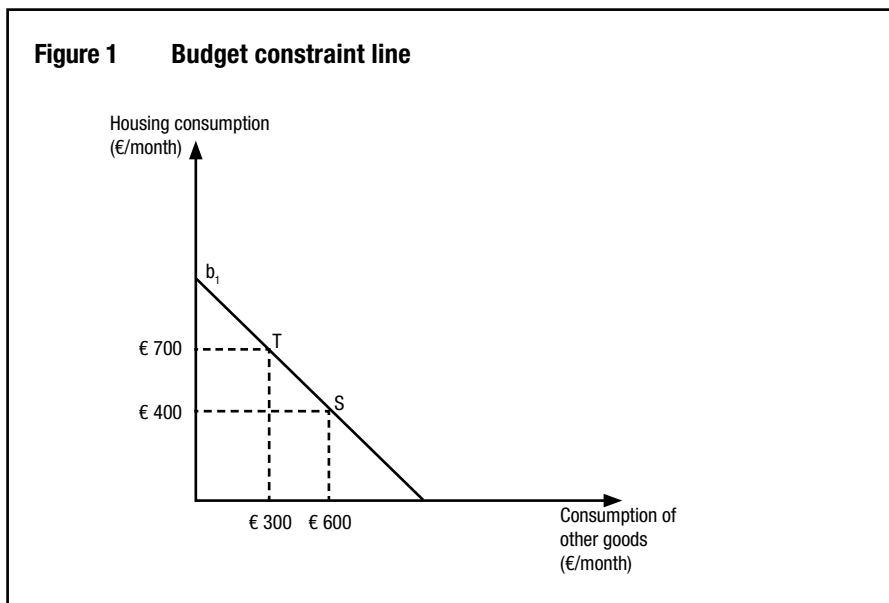
## 1. Impact on the individual household

Let's first compare both methods from the viewpoint of the individual consumer. Therefore we will use the example of a rental tenancy. The classic model of indifference curves is used to show the difference. For an economist this is an open door and they will move quickly through this first part. Non-economists will find here the economic reason why individuals are better off with demand side subsidies.

The starting position is a household with a monthly disposable income of € 1000. That income will have to be split between the rent and other goods. Many spending "mixes" are thinkable.

As can be seen on figure 1 all these combinations are on a straight line, called the budget constraint line. As the income of this household is not too high we suppose that it will spend each month its full disposable income of € 1000. Its spend "mix" of housing and other goods will thus be a point on the budget constraint line  $b_1$ .

Of course it is not realistic to spend € 1000 on rent, and starve from hunger. The opposite, spending € 1000 on other goods but living on the street seems also quite unrealistic. The household of course looks for a mix that yields a maximum utility. Economists use for that purpose "indifference curves". Each point on an indifference curve represents the same consumption value for the household - Fig. 2 shows we see a set of 3 indifference curbs:  $i_0$ ,  $i_1$  and  $i_2$ .



Each point on the curb  $i_1$  represents a higher consumption value to the household than a point on the curb  $i_0$ . And each point on the curb  $i_2$  represents more value to the household than a point on curb  $i_1$ .

For simplicity only 3 Indifference curbs are shown on fig.2, corresponding with 3 different consumptions values. An infinite number of slightly different consumption values in between and along  $i_0$ ,  $i_1$  and  $i_2$  can be imagined. All those indifference curbs of the household never intersect, because they each represent a different value. Every household has its own specific set of indifference curbs as they might value housing and other goods in a different way.

With a budget constraint of € 1000 the household could choose for a mix € 700 on housing and € 300 on other goods (point T) or for a mix € 400 on housing and € 600 on other goods (point S). Intuitively we feel that the latter combination S will be preferred above T that leaves not much money for food etc. This is confirmed by

**Table 1: Spending mix**

Rent	Other goods
€ 1,000	€ 0
€ 900	€ 100
€ 800	€ 200
€ 700	€ 300
€ 600	€ 400
€ 500	€ 500
€ 400	€ 600
€ 300	€ 700
€ 200	€ 800
€ 100	€ 900
€ 0	€ 1,000

the indifference curbs of this household: point S is part of indifference curve  $i_1$  which yields a higher utility than indifference curb  $i_0$  hosting point T. In the point S, the indifference curb  $i_1$  is tangential to the budget line  $b_1$ . The budget line  $b_1$  has no intersection with a higher ranked indifference curb. This means that a mix of € 400

housing and € 600 other goods is the spending mix that yields the most of consumption value that this household can get with a budget of € 1000 a month.

We are now very well equipped to dive into the world of supply and demand subsidies. Three examples will be used to illustrate the differences between demand – and supply side subsidies.

## ***A rental voucher of € 250 that can be used by the tenant in the rental dwelling of his choice.***

The budget constraint line shifts now from  $b_1$  to  $b_2$ , as € 1250 can now be spend. With a budget of € 1250 the household gets access to the higher  $i_2$  indifference curb at the point A where this curb is tangent to the budget constraint line  $b_2$ . The spending mix is now € 500 for housing, giving access to a dwelling with a 25% better quality, and € 750 for other goods, also a 25% increase. Both increases do not need to be proportional, that depends upon the individual preferences that shape the form of the individual indifference curbs.

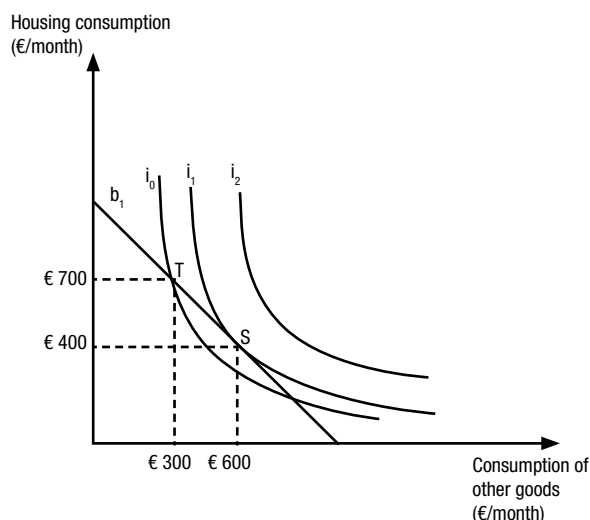
## ***Moving to an even better social housing dwelling, that received a supply subsidy of € 250***

Social housing providers rent out a dwelling with a market rent of € 650 for € 400. Our household is on top of the waiting list and relocates into this social housing rental unit. The price/performance is excellent as the price is 38% below market price. But in this case the household still has only € 600 to spend on other goods. This situation is represented by point B. This point is on a virtual budget constraint line of € 1250 representing the household disposable income of € 1000 plus the € 250 subsidy. But with the supply side subsidy to the social housing company the household is not able to choose its own optimal mix. Point B is situated on an indifference curbs situated somewhere between  $i_1$  and  $i_2$  and thus does not achieve the same consumption value as in point A (rental voucher) situated on the higher valued indifference curb  $i_2$ . The supply side subsidy is in this case about 33% less efficient than the corresponding demand side subsidy, which means that in this case 33% of the money of the supply side subsidy is wasted.

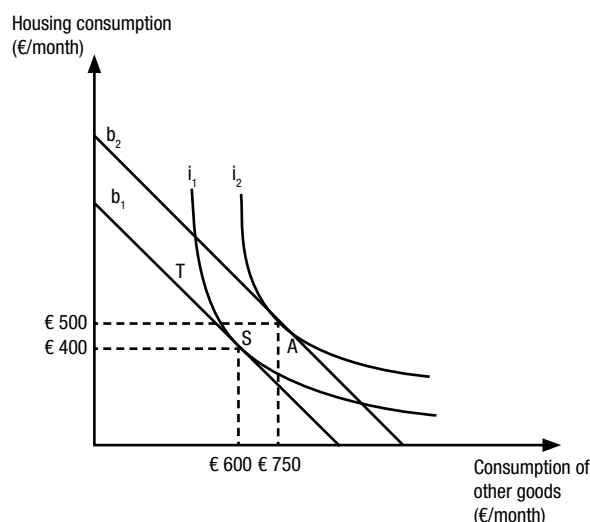
The individual households are better off with demand side subsidies than with supply side subsidies because that they have more freedom to choose the spending mix that yields the highest consumption value for them.

In general social housing systems function with waiting lists and therefore the households have

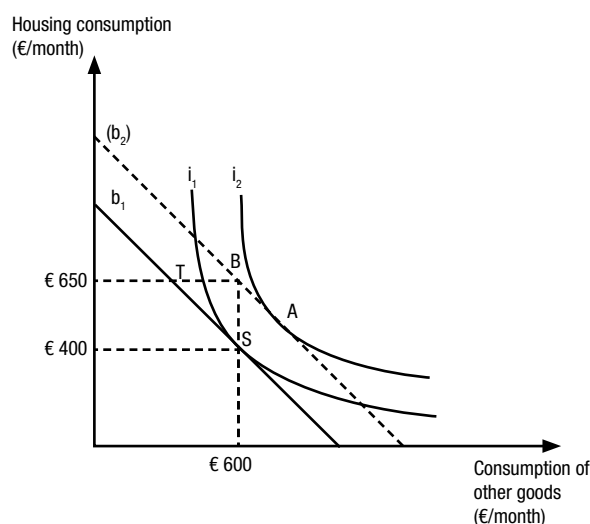
**Figure 2 Choosing the optimal mix using indifference curbs**



**Figure 3 Demand side subsidy of € 250 by means of a rental voucher**



**Figure 4 Supply side subsidy for a social housing dwelling**





few immediate choices about the location, the type and quality of their future home. A waiting list means also a waiting time, that can be several years. And when a home is offered, the temptation to accept it is great, as a refusal is risky, and the household is still better off than without a solution. This allocation mechanism inherently leads to mismatches between the optimal solution (the point A) and the accepted solution (point B).

In the example above, supply side subsidies are also linked to a specific actor, a social housing company. These housing companies often have a local monopoly. This means that if they operate in an inefficient way, with a mismatch between their offer and the needs of the market, or with too high costs, there is no real market sanction. There is also the risk of unfair competition that becomes bigger when expanding into mainstream housing.

From a customer satisfaction and resource allocation standpoint, demand side subsidies are clearly preferable to supply side subsidies. However a problem arises with demand subsidies in inelastic markets; this will be discussed in the next section.

## 2. Price increases with demand subsidies in an inelastic market

Imagine a lower private rental market segment with rents in the range of € 250 - €500. Demand

subsidies of on average € 250 are given to 25% of the households with the lowest disposable income in that market. The same number of households will compete for the same number of dwellings but now with 25% of them with a significantly higher budget. Prices will rise.

If the housing stock is abundant compared to demand, this is not a problem. This is the case in several European regions. Additional available units will be brought to the private rental market, and the price rise will be very limited (figure 5, point E).

If on the contrary the housing stock is constrained, no supply solution can be found directly in this market segment, and prices will rise significantly (fig. 5 point I). Rents in the range of € 250 - € 500 do economically not allow new construction. The higher rental prices then have a double effect: the voucher amount must be larger to obtain the same relief for the 25% subsidized tenants. But prices would also rise for the 75% of tenants that are not in the voucher program!

## 3. Supply side subsidies for newly build rental social housing

By building additional social housing the total housing stock will increase and demand can be offloaded from the private rental market. But nowadays several issues make it more

difficult to achieve sufficient extra capacity, with this solution:

- Standards for new housing, also social housing, have for reasons of energy efficiency and general comfort become very high. Land becomes also scarce. This has increased the cost of new construction. On the other hand the proportion of people on the waiting lists with very low incomes becomes greater. The subsidy gap between the cost of new- build social housing, and what poor future tenants can pay is of course higher than for renting out the existing stock. In Belgium the equivalent of a monthly subsidy of 500-700 € a will be necessary to bridge the gap between the full cost of a new social dwelling and what the future poor tenant can pay. The high level of additional subsidies required for the financing of the interest is also a burden for the budget equilibrium.

- The expansion of the social rent stock is often financed through long term loans, guaranteed by the state or the regions. However the banks face a triple challenge with this type of finance:

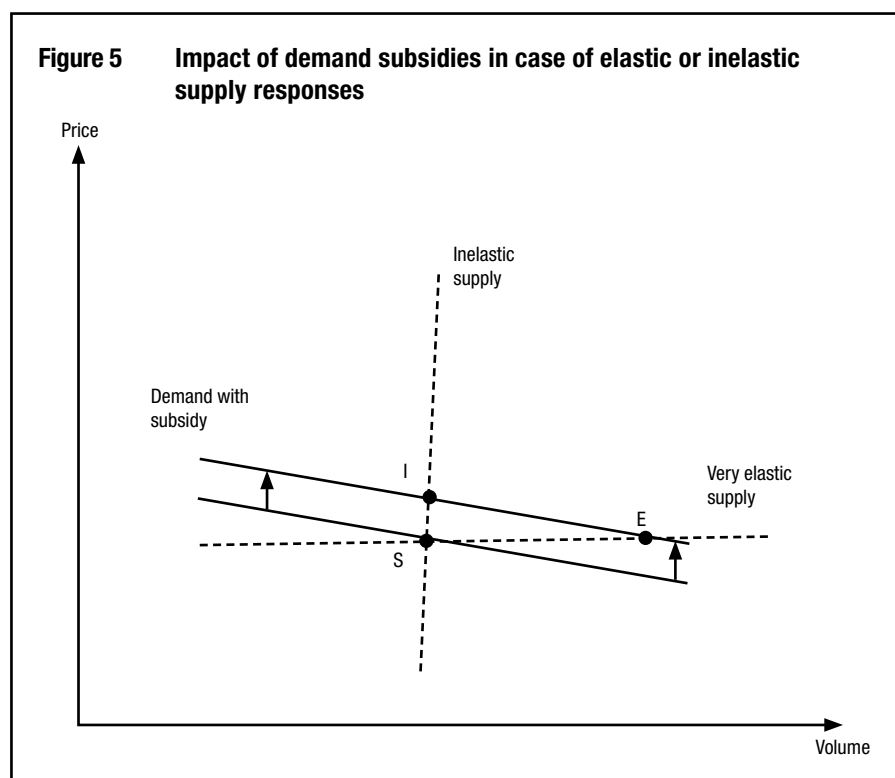
- Credit ratings of many states and regions are now lower than they were before. The lending then will require more capital for the banks than before;

- Lending for 30 years or more can also affect the liquidity of the bank;

- If a fix interest rate is required, banks will face an interest rate risk, as funding on such a long period at a fixed rate is not readily available in the market. Of course interest rate swaps (derivatives) can be used, but they also involve credit risks when a counterparty does not perform.

- Putting out additional long term guarantees does not help for the rating of the state or the regions;

- Some social housing companies face a need to renovate or rebuild part of their actual stock. Tenants need to be relocated during the renovation or rebuilding period, which for apartment building can take many years. During this effort new- build social housing will also have to be used to relocate the tenants that have to leave their actual dwellings: part of the capacity of the new construction will have to be used to relocate existing tenants.



## 4. Hybrid subsidies to grow the private stock of standard homes

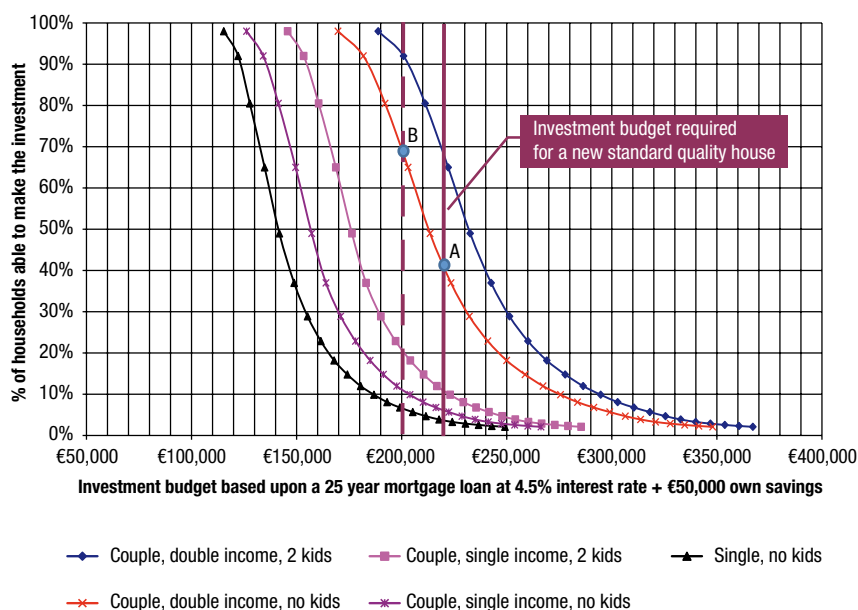
Somerville and Mayer (2003)<sup>1</sup> concluded that the availability of affordable rental housing in American Metropolitan statistical areas is largely influenced by the regulation on the construction of new homes:

- “We find that, consistent with theoretical models of housing, restrictions (land use regulations & fees) on the supply of new units lower the supply of affordable units”
- “We find this a compelling result, clearly identifying the linkage between construction of new high- and standard-quality homes and the affordable stock consisting of lower quality units (lower tier of the private rental market)”.

Research by a Dutch governmental planning institute found that each newly occupied house leads to a chain of additional relocations of households (on average 2,5 additional moves on top of the initial one to the new house). Where new houses are occupied by more well off households, they free up other houses further in the chain of relocations that are occupied by households that have lower incomes<sup>2</sup>.

This means that the remediation of the supply shortage in the lower private rental market can also be achieved by new construction for middle income households segments. The advantage to do so is that few subsidies are required as the bulk of the investment is privately paid for by those middle income households. Albrecht and Van Hoofstat (2011)<sup>3</sup> found that for Belgium the price elasticity for new construction is potentially very high. The diagram below shows that the percentage of households able to invest in a newly build house is very sensitive to the required investment budget. Point A on figure 6 indicates that, with a mortgage loan at 4.5% over 25 years and an extra € 50.000 of financial savings, about 40% of couples with a double income and no kids are able to acquire a new standard quality house. Households that can't afford a newly build house buy existing houses, that can be bought for lower prices than new ones. But in this way they don't contribute to the necessary expansion of the housing stock.

**Figure 6 Investment limits of different types of households in Belgium (2011)**



Source: FOD Economy ADSEI, Federal social security, own calculations

Instead they may even source their acquisition from the private rent housing stock.

With a subsidy of € 20.000 the required budget would only be € 200.000, and point B now indicates that 70% of that type of households could again get access to a newly build house. The prime purpose of such a subsidy is to change the preferences of the target group more towards acquiring a newly build house instead of “consuming” one of the existing stock.

The subsidy is targeted to middle income households that don't own a house yet. The objective is to lower the cost of a newly build house for the target group. The purpose is to compensate for the very high charges that exist in Belgium on new construction, due to an accumulation of 10-12% of acquisitions cost on the land, labor charges that are among the highest in Europe, topped by 21% VAT on the whole. Although it is strictly speaking, a demand side subsidy, the prime purpose is definitively to encourage the creation of extra standard quality houses.

But the household is still responsible for using the subsidy in the most effective way, tailored to its own preferences. The subsidy is not linked to a specific actor, type of home (apartment or terraced), location or contractual format. Such a subsidy is of a hybrid nature, combining a supply side objective with demand side means, in the market of newly build proprietary homes.

## 5. Combining different markets and subsidies for the best overall solution

The proposal for Belgium by the Itinera Institute is to combine demand side subsidies in the private renting sector with hybrid subsidies for new- build standard owner-occupied houses.

The demand side subsidy enables poor households to pay a normal rent, while the parallel hybrid subsidy increases the housing stock of standard homes so as to prevent a rise in rent. The authors of the proposal calculated that

<sup>1</sup> C. Tsuril Somerville (University of British Columbia) and Christopher J. Mayer (University of Pennsylvania, Wharton School), Government regulation and changes in the affordable housing stock. FRBNY Economic Policy Review, June 2003, pages 45 and 50.

<sup>2</sup> Planbureau voor de Leefomgeving (NL), Nieuwbouw, verhuizingen en segregatie. 2010, pag. 131

<sup>3</sup> Johan Albrecht (Itinera Institute) and Rob Van Hoofstat (Adprimum), Huisvesting in tijden van schaarste - Pénurie d'habitat, Roulaarta Books, June 2011.

such a solution would cost significantly less than doubling the stock of public rental houses.

When designing subsidy systems one should consider the whole of the housing market as an interrelated system. In the case above the supply problem in the private rent market is not tackled by a massive new supply in the social rent sector but by making the acquisition/construction of new- build standard quality homes again more affordable for average households.

## 6. Conclusion

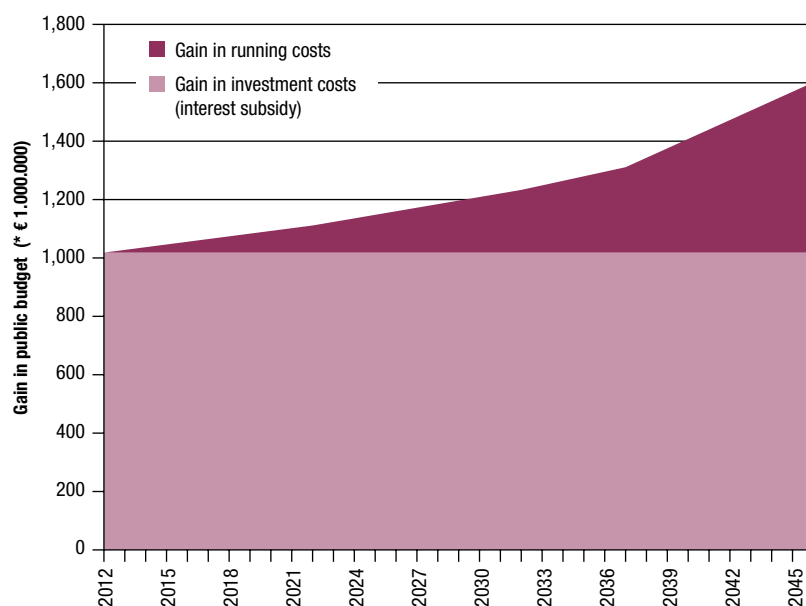
Demand side subsidies are economically more efficient than supply side subsidies provided that the supply is elastic.

If supply of a market is inelastic, one should not directly switch to supply side subsidies in that same market. The root cause of the supply shortage or demand overrun may very well reside in a feeding or substitute market. The primary construction market feeds the existing housing stock, and the best way to counter a price explosion in the secondary market is to enhance the supply of newly build houses. This will also liberate, though the relocation chain of the households, more houses for the private rental market, thus taking away pressure from its substitute, the social housing sector.

If supply is there elastic, it can be more efficient to remediate the root cause in that other market with demand side subsidies, or by lowering taxation.

Demand side subsidies can also easily be tailored to produce a desired type of supply, for instance new standard quality energy efficient homes, thus becoming hybrid subsidies. Even then they still offer more choice to the end user and promote a level playing field on the supply side, open to competition.

**Figure 7** Possible gains in public spending



# Investment in housing – a growing new case for supply-side subsidies

↪ By Rudy de Jong

## 1. Introduction

The question as to whether subsidies for housing should be directed at demand or supply has been a matter of passionate academic and policy discussion. One could wonder why this question is often so controversial. In well-operating markets the impact on output and on the price paid by the consumer will be the same in either case. However reality is different and discussions have to do with much more than just the economic and social impact of public interventions on housing markets. Ideology and institutional interests often stand in the way of a proper analysis of the merits of certain instruments in given circumstances.

Over the last few decades we have seen a shift away from supply-side to income-related subsidies in most European countries. In a period of growing national income, improving social security systems and decrease of population growth this development could be seen as a comprehensible response to changing circumstances. But things have changed. In this contribution I argue that because of the fundamental crisis in European economies and societies this policy has to be changed. In many European countries there is a growing and sometimes a new case for supply side subsidies answering urgent needs for available and affordable housing.

## 2. Dramatic shift

Since about 1980 in many European countries there has been a dramatic shift of public expenditure from supply-side subsidies towards income linked subsidies (Oxley 2007, Whitehead & Scanlon 2007). This shift followed a change in political and ideological preferences from

collective welfare state supply to arrangements, based on individual freedom of choice. In housing market policies there has been an important shift in preference from (social) rental housing to private home-ownership.

It is likely that this 'dramatic shift' has much to do with wider economic and demographic developments in post-war Europe. In the first decades of large-scale housing shortages and little ability of market forces to produce additional housing, governments have chosen to subsidise production. With housing allocated according to needs rather than ability to pay, both supply and affordability objectives could be tackled (Oxley 2007, p4). But with growing household incomes and decreasing housing shortages additional instruments had to be introduced to increase the efficiency of the system by targeting subsidies more on the individual purchasing power of households.

## 3. The question: support supply or demand

International experience is not conclusive with regard to the most appropriate system of subsidised housing. Much depends on general economic conditions, demographic and social developments, the level of wealth and income inequality, existing institutional frameworks and many inter-related factors of government policies.

Nevertheless supply and demand side subsidies have both their own characteristics and pros and cons.<sup>1</sup>

Supply-side subsidies are in general more effective to reach public interest objectives like the quality and functioning of urban regions,

flexibility of labour supply, sustainability and community cohesion (Oxley 2007, p4). There is also growing evidence that supply side subsidies produce more additional housing output compared to demand side subsidies (Whitehead, 2004, p15) and that supply of social housing contributes to macro-economic stability (EC 2011, p44). On the other hand supply-side subsidies entail complex distribution questions and narrow down individual choices, which in economic terms can be regarded – and calculated – as welfare losses.

Demand-side subsidies are in general more efficient to fulfil policy objectives regarding affordability as these are better targeted at the specific financial needs of individual households. There is also some evidence that housing benefits are less harmful for mobility than direct provision of social housing (OECD 2011B, p67). On the other hand demand-side subsidies easily contribute to the so-called 'poverty trap', which means that low-income households are discouraged from becoming economically more active because the higher income will lower the housing allowance (Besseling cs 2008, p23, OECD 2011B, p55).

The final impact of different kinds of subsidy for housing depends much on the characteristics of a specific housing market. Especially important is the so-called 'elasticity' of supply and demand in the housing market.

According to Whitehead (2008, p37) almost all the general econometric models indicate that the responsiveness of prices to changes in demand for housing is less than the responsiveness of incomes to changes in demand. So when incomes rise, house prices will rise in the short term. In housing markets where supply is relatively inelas-

<sup>1</sup> A comprehensive overview of characteristics and pros en cons of public interventions in housing markets can be found in Besseling cs, 2008 and OECD 2011B.



tic this will also be a long term phenomenon. In these markets higher purchasing power as a result of subsidies or tax incentives will be translated into rising house prices.

This phenomenon can clearly be seen in the Netherlands where because of dense population and restrictive government regulation one of the least elastic housing markets in the western world can be found (OECD 2011B, p26-30). The almost unlimited demand-side tax-deduction of paid interest on mortgages is to a large extent not reflected in the supply of housing but in the price of dwellings and land (Besseling *cs* 2008, p32). This 'capitalization' effect of demand-side subsidies in housing markets with a low supply elasticity can contribute to high rents, affordability problems and shortages (Oxley 2007, p5. Amman 2012, p32).

The effectiveness and efficiency of supply-side subsidies also depend much on the income distribution in a country. In the early post-war period a large percentage of the population in North and West-European countries consisted of young households with relatively low incomes. So the problem of targeting supply-side subsidies was small compared to the last decades of the 20th century with growing incomes for many households. Also the currently felt lack of choice must have been almost absent.

In those days income subsidies would have been much less effective because of the huge housing shortage in many countries but also because of the low price elasticity of the demand. In a situation where the elasticity of demand is limited above a certain basic standard of living, supply-side subsidies help people to achieve a minimum of quality as compared to income subsidies (Whitehead & Scanlon, 2007, p1-2).

### 4. Daily life complexity

As Oxley (2007, p5-6) describes, the complex and inter-linked effects of supply-side (object) and demand-side (subject) subsidies reflect in daily-life reality. There are, in practice, very few examples of either pure object or pure subject subsidies (Amman 2012, p32). Pure subject subsidies would amount to income supplements with no housing-related conditions attached. Households would be able to spend the additional resources on whatever they wished. Pure object subsidies would be used

to build new dwellings without any conditions about who occupied the dwellings and how they were priced.

The reality is that there are many variants of conditional subject subsidies and conditional object subsidies found throughout the world. It is the conditions that make them distinctive in any set of circumstances and it is the conditions that make them successful or not. Conditions attached to housing allowances usually include considerations of the size of the household, household income, and housing costs. There may also be conditions related to the size and quality of the housing occupied and there are sometimes locational elements to the conditions. The conditions also specify who gets the resources; the household or the housing supplier.

Conditions attached to supply subsidies often include considerations of beneficiaries. Distribution systems are put in place almost everywhere to link object subsidies with the households in need. The application of the conditions can turn what is superficially termed a demand-side subsidy or a supply-side subsidy in an instrument with the opposite effect (Oxley 2007, p6; OECD 2011B, p55).<sup>2</sup>

### 5. And the winner is ...

Given the variations in the conditions, generalisations about the effects of either instrument are misplaced. This underlines the conclusion in several studies that one way of subsidising is in itself not better than the other, but that it all depends on the specific circumstances and policy objectives (Besseling *cs* 2008, Whitehead *cs* 2002, 2004, Hall & Gibb 2010, Oxley 2007). In practice they tend, furthermore, to be used as complementary rather than opposing forms of housing support.

If the policy goals relate to deep supply-side problems, and there is little ability of market forces to tackle these problems in an acceptable time-frame, support for a social housing programme is likely to be more appropriate than where there are no significant supply shortages or inelasticity. If furthermore, the policy aims embrace social cohesion, improvements in the quality of the urban environment and improvements in sustainability, well-designed and well-regulated social housing programmes are likely to play an important role.

If the problem is seen as mainly an affordability rather than a supply problem and market mechanisms are deemed to be adequate to provide the required supply, there will be more emphasis on housing allowances programmes. If, in addition, there is a strong desire to promote consumer choice, and capitalisation of benefits is unlikely, housing allowances will be further to the fore (Oxley 2007, p9).

Unless ideology or institutional interests take over, the result is not an outright win for either instrument. It is rather a result that will vary with aims and circumstances.

Consequently, it is most important to find the right balance between the public interest concerned and the positive and negative effects of instruments and conditions in the given circumstances. This is called the 'Calculus of the public interest', a systematic trade-off between the pros and cons of government intervention (Teulings *cs*, 2005, p132-133). The result of this Calculus will not make a choice in the debate between the disciples of demand-side or supply-side subsidies, but will combine the best of both worlds. This necessity of finding an appropriate balance between instruments depending on specific market conditions has recently been confirmed by international institutions (EC 2010, p264-265, OECD 2011, p71-75).

### 6. The new case for supply-side subsidies

When circumstances change, the use of supply-side and demand-side instruments must be reviewed. Starting with the end of last century and especially after the credit crunch in 2008 and the economic downturn since then, there are important reasons for this review. Housing market circumstances are changing again in a dramatic way. Average incomes cannot keep up with inflation and unemployment and inequality in income and capital is rising in most countries (Lansley 2011, OECD 2011A, ILO 2012). Population growth is slowing down or has turned into decline.

A central element in the worldwide economic crisis is, starting in the 90th of last century, the over-supply of credit to inelastic housing markets, resulting in price-bubbles plus decreases in supply and mobility and reduced affordability (Cecodhas 2012) In many countries waiting lists for social housing are growing while at the same

<sup>2</sup> It is interesting that in making the case for demand subsidies Filiep Loosveldt (Loosveldt 2012, p29) is also adding conditions to demand subsidies that turn them to a large extent into supply subsidies.

time the relative share of social housing in the overall stock has fallen (OECD 2011B, p44).

These developments create new circumstances which demand supply-side interventions in the housing market. This is happening already. In several countries social housing investments cover a growing percentage of total housing market investments and show this way their counter-cyclical character. In the Netherlands in 2011 almost 70% of all investments in new housing has been done by social landlords.<sup>3</sup> This confirms the growing importance of supply-side interventions in periods of stagnating economies and housing supply and the stabilising role of social housing in economies. This has been recently recognized by the European Commission who considers housing market stability as a key point in the new European economic governance (EC 2011, p44).

The only conclusion from all this must be that the changing social and economic landscape calls for a fundamental review of public interventions in housing markets all over Europe. A new balance between demand-side and supply-side instruments has to be found. In finding this balance the downturn of European economies, growing inequality and stagnating housing supply will put a much stronger weight on the supply-side than we have seen for a long, long time.

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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