

HOUSING FINANCE INTERNATIONAL

The Quarterly Journal of the International Union for Housing Finance



- ➔ **An Overview of the Canadian Housing Finance System**
- ➔ **The Role of Mortgage Securitisation in the Financial Crisis and How to Restore the Market's Health**
- ➔ **The Planning System and Land Provision for Social Housing in Turkey**
- ➔ **Flexibility, Security and Efficiency of Security Rights over Real Property in Europe**
- ➔ **The Private Rental Market in Flanders: Growing Poorer**
- ➔ **Housing Finance in India: An Overview**

International Union for Housing Finance

Housing Finance International

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Editor's Introduction

↪ By Andrew Heywood

The optimism that characterised commentary on the global economy in recent months has been severely qualified by recent developments. The possibility of a double-dip recession is now being taken more seriously again as growth figures and other indicators begin to paint a more equivocal picture. Concern about economic prospects is increasing in the USA and in the UK which is already witnessing what appear to be the early stages of a second downturn in the housing market following a partial recovery in the second half of 2009.

Talk of economic downturn is becoming inextricably linked to discussions of national fiscal policy as more governments seek to reduce their budget deficits and accumulated debt following the economic stimulus packages of recent years.

The articles in this edition of HFI touch on a number of topics that have particular relevance to those dealing with housing finance issues in a tougher economic and fiscal climate.

Virginie Traclet provides an insightful overview of the Canadian housing finance system and offers an instructive analysis of why it proved itself relatively resilient during the market turbulence of 2007-2009. She points to some telling contrasts with the US market, drawing attention to the much lower level of mortgage delinquencies and to the more modest role played by the sub-prime sector within the Canadian mortgage market. She discusses the role of regulation in promoting sound lending in Canada and discusses issues relating to mortgage funding as well as examining specific features of the Canadian market such as compulsory mortgage insurance on high loan-to-value mortgage loans.

Otmar Stöcker will be known to many readers of HFI as a lucid, critical and determined industry representative in relation to EU Commission proposals for Europe-wide retail mortgage regulation. In his article for HFI however he returns to his long-standing interest in the use of collateral. His article discusses an important comparative study published by the Association of German Pfandbrief Banks (vdp) on security rights over real property in Europe. Bringing together specialists from 24 countries the study draws together important material. The article makes a powerful case for the importance of a clear understanding of the role and function of security in different jurisdictions for those participating in European mortgage markets at the present time.

In this the second of a two-part examination of the impact of the financial crisis on mortgage funding markets, Rob Thomas focuses on the part played by securitisation in the financial crisis and the response of policymakers in the UK compared to their counterparts in Europe and the US. Thomas takes a sceptical look at some of the arguments marshalled against the role of securitisation in the crisis; for example he is critical of the view that lack of transparency and an asymmetry of information between issuer and investor was a major contributor to poor decision making in the run-up to the crisis. The article goes on to set out an approach to restoring the market for residential mortgage-backed securities. Though the article has a UK policy focus it has much wider relevance.

In their fascinating article, Sevkiye Sence Turk and Willem Korthals Altes examine the changing approaches to using the planning system to secure land for the provision of social housing in Turkey during the post World War II period. They analyse the implications of the existence of both legal and illegal approaches to land development over time and the interaction of state and other organisations such as co-operatives with a changing planning system.

There has been increased interest in the private rental sector in a number of countries as public policy makers grapple with reduced budgets and the need to house a section of people for whom neither owner occupation nor social renting are appropriate. In her article *The private rental market in Flanders: growing poorer*, Sien Winters offers a well-evidenced analysis of trends within the private rental market in Flanders. She points to a history of long-term decline in the proportion of private tenants and to deterioration in the socio-economic profile of tenants. She identifies a number of causes for these phenomena including low returns experienced by landlords and the effects of housing policies geared towards promoting owner occupation.

With the next IUHF World Congress due to take place in India in 2011, an overview of the housing finance system in India is timely. Renu Sud Karnad puts the evolution of housing finance in India within the context of broader economic development, demographic factors and population movements. Ms Karnad offers a helpful introduction to the main players in the Indian mortgage market the regulatory environment, together with an insight into mortgage products and mortgage funding. She also briefly examines the impact of the

global financial crisis and looks at the challenges of providing affordable housing.

Finally, as a consequence of the economic crisis and against the backdrop of cutbacks in government spending, in many countries those concerned with the development and management of social housing find themselves facing some major strategic questions about the future. The forthcoming International Social Housing Summit in The Hague on 13th and 14th October is well-timed to take up the issues and to offer a comparative perspective (for further details visit www.ishsum.com).

The Summit draws on academic and professional expertise from around the world to offer an impressive programme of plenary and breakout sessions covering some of the key issues facing social housing markets and providers. Many of the sessions are grouped around three themes:

- Financing social housing
- Sustainable social housing
- Demographic challenges.

Europe is well represented in terms of both the subject matter of sessions and the speakers but the programme ranges wider, with sessions covering issues and events in the US, Asia and Australia. The title of the opening keynote speech from Professor Duncan MacLennan is *What is the state of social housing worldwide?* It looks likely to set the scene for what is to follow.

Inevitably the opportunity to network and discuss issues informally is at least as important as the quality of the programme itself. The Summit organisers promise attendees the opportunity to meet a multi-national group of over 300 senior social housing practitioners drawn from landlords and providers, developers, lenders, academics, policy decision makers and others.

HFI regularly covers social housing issues from across the globe with the aim of enabling comparisons to be made and innovative practice identified. This year the IUHF and HFI are taking their involvement one stage further; IUHF Secretary General Annik Lambert and I will attend the Summit to take part in round table discussions and a panel as part of the programme. A report on the Summit will appear in the winter edition of HFI.

Andrew Heywood

Contributors' Biographies

Dr Virginie Traclet is Principal Researcher in the Financial Markets Department of the Bank of Canada where her responsibilities include the analysis of financial market developments and their impact on the stability and efficiency of the Canadian financial system. Prior to her current position, she specialised in housing finance and represented the Bank of Canada for the CFGS Report on *Housing Finance in the Global Financial Market* (2006).

Dr Otmar Stöcker has been Managing Director since 2001 of the Association of German Pfandbrief Banks. He has worked for the Association since 1989, heading up the "Covered Bond law and International Business" section from 1997 – 2007. He has dealt extensively with mortgage law and the law of covered bonds in Europe in several monographs (including "Die Eurohypothek") and numerous academic papers. Since 1993 he has acted as a consultant in Central and Eastern Europe in relation to the modernisation of the legal structures for real estate financing. He lectures at the University of Warsaw.

Mr Rob Thomas. After gaining undergraduate and masters degrees in economics, he joined

the Bank of England as an economist in 1989 moving to UBS in 1994. In 2001 Abbey National recruited him to manage a pan-European mortgage funding project. In 2005 he joined the Council of Mortgage Lenders.

Ms Sevkiye Sence Turk is an Associated Professor at the Department of Urban and Regional Planning in Faculty of Architecture, Istanbul Technical University. Her main interest is focused on the relationship between planning and land development processes.

Mr Willem K. Korthals Altes is a Professor in Land Development at the OTB Research Institute for the Built Environment, Delft University of Technology. His main research interest is focused on the relationship between planning and markets in relation to the development of the built environment.

Ms Sien Winters (1961) has a Master in Economics and a Master in Educational Sciences. She is research housing manager at the Higher Institute of Labour Studies (HIVA – K.U.Leuven) and co-ordinator of the housing team of the Flemish Policy Research Centre

on Spatial Planning and Housing. She is also member of the Advisory Board for Housing of the Flemish Government.

Ms Renu Sud Karnad, Managing Director of Housing Development Finance Corporation Limited - India (HDFC), is a graduate in law from the University of Mumbai and holds a Master's degree in economics from the University of Delhi. She is a Pravin Fellow – Woodrow Wilson School of International Affairs, Princeton University, USA. She is a former President of the International Union for Housing Finance. She has been employed with HDFC since 1978. Apart from HDFC, Ms. Karnad is on the board of several HDFC group companies and a number of other leading corporations.

An Overview of the Canadian Housing Finance System

↪ By Virginie Traclet¹

1. Introduction

Historically, the Canadian housing finance system has not been a major source of risk to financial institutions and, more generally, to the stability of the Canadian financial system as a whole. This has also been true recently: the Canadian housing finance system has proven resilient during the financial crisis – in particular compared to the United States – as illustrated by a much more limited deterioration in mortgage delinquencies (Figure 1).

The Canadian mortgage market has occasionally been described as offering a limited choice of mortgage products and limited access to mortgages for some groups of borrowers (IMF, 2008). This assessment, however, is somewhat difficult to reconcile with the fact that the homeownership rate in Canada is similar to that in other developed countries, including the United States (Figure 2).

Moreover, the Canadian housing finance system, like that in many other countries, has experienced significant changes over the past two decades (in terms of product innovations, funding, competition etc.) as a result of macroeconomic developments, advances in information technology, financial innovations, and globalisation of capital markets (CGFS, 2006). Overall, this suggests that the policy framework for housing finance in Canada has not hindered mortgage innovation or had a detrimental impact on homeownership, although it guided innovation in a manner that contributed to the resilience of the system.

A number of hypotheses have been put forward to explain this outcome. This article contributes to this discussion by providing an overview of the Canadian housing finance system and highlighting some of the key features that have contributed to its resilience during the recent

Figure 1 Mortgage delinquencies, Canada versus United States

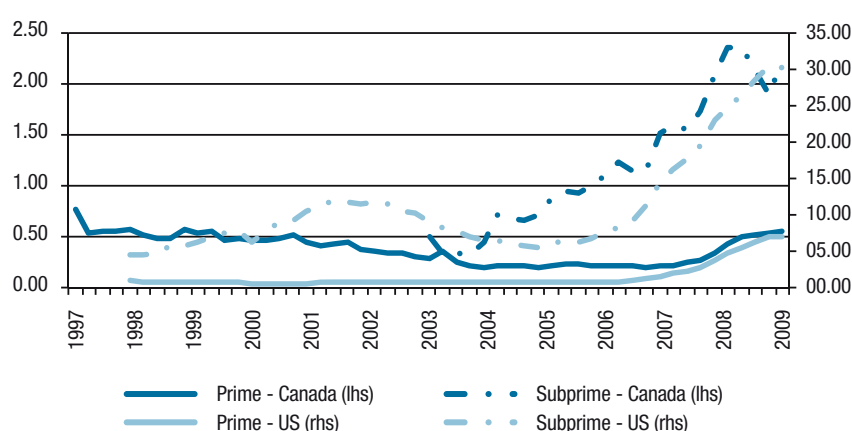
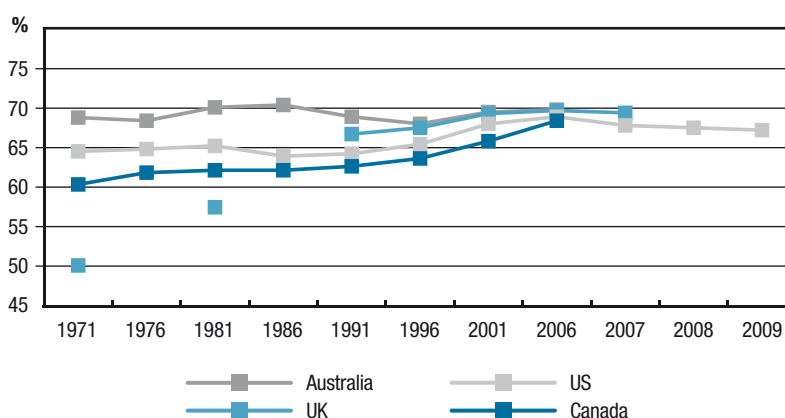


Figure 2 Homeownership rates – international comparison



Sources: U.S. Census Bureau, Statistics Canada, UK Department of Communities and Local Government, Australia ABS Census Data

crisis, pointing to some of the major differences with the U.S. system. We also review recent developments in the Canadian system, prior to the crisis and as a result of the crisis.

This article is organised as follows. Section 2 describes the regulatory framework for, and role of the government in, the Canadian housing finance system. Section 3 describes the key features of the

¹ The views expressed here are those of the author. No responsibility for them should be attributed to the Bank of Canada. I would like to thank Allan Crawford, Jason Allen and Alex Sebastian for their comments and suggestions and Etienne Bordeleau-Labreque for his technical assistance.

Canadian mortgage market (products and lenders). Section 4 details the key features of, and recent developments in, mortgage funding. The last section focuses on the developments in the system in the years preceding the financial crisis and highlights how Canadian authorities have adjusted the housing policy framework, drawing lessons from the crisis in the U.S. system, so as to ensure that developments in housing finance do not cause instability in the financial system and/or economy.

2. Regulatory framework and the role of the government in the Canadian housing finance system

2.1. Role of the government in the Canadian housing finance system²

Government policies play an important role in national housing finance systems in most industrialised countries, although the form these policies take varies across countries (CGFS, 2006). In Canada, the legal framework for housing policies is provided by the National Housing Act (NHA), introduced in 1944 to consolidate all housing legislation and give the federal government – through the Canada Mortgage Housing Corporation (CMHC) – a leading role in housing programs. While the influence of the federal government on the housing finance system was direct in the two decades following the Second World War (for instance through direct mortgage lending by the government and regulatory ceilings on interest rates), this influence became more indirect over time, with the overriding objective of increasing the supply of mortgage loans from private lenders. Mortgage insurance played a pivotal role in supporting this objective: the introduction of a legal requirement for insurance for high-ratio mortgages, i.e., mortgages with a loan-to-value (LTV) ratio exceeding a certain threshold, created the incentive for lenders

to provide mortgage loans since the insurance protects them against borrower default. In 1954, the government expanded the NHA and the Bank Act was revised so as to allow chartered banks to provide mortgages insured under the NHA.³ As illustrated in section 5, mortgage insurance has continued to play an important role in influencing developments in the Canadian housing finance system over time.

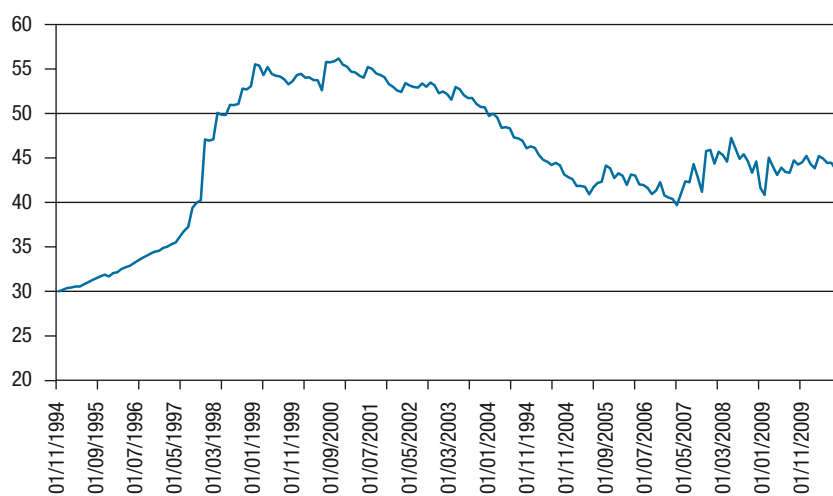
2.2. Key features of mortgage insurance in Canada

It is common practice for mortgage lenders in a number of industrialised countries to use mortgage insurance of some form for mortgages with an LTV ratio exceeding a certain percentage (80% in the US and Australia, typically 75% in the U.K.). In Canada, mortgage insurance for high-ratio mortgages is *required by law* for regulated institutions.^{4,5} Moreover, mortgage

insurance in Canada has a number of features that differ from other countries.

First, although the legal requirement states that the insurance should cover the amount of the loan that exceeds 80% of the value of the property, in practice high-ratio mortgages are insured for the total value and entire life of the mortgage.⁶ Second, mortgage insurance can be provided by either CMHC (the federal agency) or private mortgage insurers provided they have been approved by the Office of the Superintendent of Financial Institutions (OSFI) and relevant provincial authorities.^{7,8} Finally, both publicly and privately insured mortgages benefit from an *explicit* government guarantee. For mortgages insured by CMHC, the government guarantee comes directly from CMHC's Crown Corporation status. Since insured mortgages backed by an explicit government guarantee benefit from a preferential treatment for regulatory capital purposes (zero risk weight), the government provides an explicit guarantee to

Figure 3 Insured mortgages as a percentage of total mortgages



Source: OSFI

² In this article, we focus on the "broad" housing policies aiming to facilitate access to the private mortgage market. We do not cover the affordable/social housing policies which seek to provide housing to specific/targeted groups of people. Various players are involved in affordable housing: federal and provincial governments, municipalities, private and not-for-profit organisations. The partnerships between these players as well as their initiatives can take many different forms (homeownership subsidies, rental subsidies, land donation for affordable housing etc.). Overall, in Canada, the government policy does not explicitly favour homeownership over rental housing, a difference with the United States which is reflected in the homeownership rate for households in lower income groups (almost half of U.S. households in the lowest income quintile own their home compared to 38% in Canada).

³ The Bank Act was further modified in 1967 to allow chartered banks to provide conventional mortgages.

⁴ In countries where there is no legal requirement to purchase insurance for high-ratio mortgages, the incentive for lenders to purchase mortgage insurance comes from regulatory capital adequacy considerations: to qualify for a lower risk-weight applied to mortgage loans for capital adequacy purposes, the loans must either have an LTV ratio below a certain threshold or be covered by mortgage insurance.

⁵ The LTV ratio above which mortgage insurance is required was previously set at 75% and was decreased to 80% in 2006.

⁶ This is different in the US for instance: mortgage insurance can be cancelled when the borrower has a satisfactory payment record and the principal balance has been reduced to or below 80%.

⁷ The mortgage insurance market is currently shared by two big players, CMHC and Genworth Financial. Another private mortgage insurer, Canada Guaranty Mortgage Insurance Company, recently entered the market but presently has a very limited market share. A few private mortgage insurers had been approved to begin operating in Canada before the financial crisis. As the latter affected the operations of their U.S. parent companies, these new players either withdrew from Canada (PMI Canada) or were acquired by Canadian investors (AIG United Guaranty Mortgage Insurance Company Canada, now Canada Guaranty).

⁸ Private mortgage insurers are subject to capitalization guidelines set by OSFI, their regulator. CMHC, although not regulated by OSFI, abides by the same capital guidelines; moreover, CMHC operates its insurance business on a commercial basis (i.e., premiums, fees and interests must cover claims and other expenses) with no assistance from the government and makes provisions for insurance policy liabilities in accordance with prudent actuarial practices.

privately insured mortgages as well to guarantee a level-playing field.⁹ While eligibility criteria to insured mortgages and the pricing of mortgage insurance are set by mortgage insurers,¹⁰ the government sets minimum standards in terms of borrowers' creditworthiness.¹¹

Insured mortgages currently account for 43% of total outstanding residential mortgages, down from a peak at 55% in the late 1990s (Figure 3).

2.3. Regulatory and supervisory framework

2.3.1. Regulation and supervision of mortgage lenders

The regulation of housing finance activities in Canada provides consistent requirements among lenders, notably in terms of mortgage insurance and disclosure requirements. Chartered banks are regulated at the federal level by OSFI; their legal framework – the Bank Act – requires mortgage insurance when the loan exceeds 80% of the value of the property (Article 418) and full disclosure of information related to mortgage loans, notably borrowing costs (Article 450). While credit unions and caisses populaires are provincially incorporated and therefore almost exclusively regulated at the provincial level, their legislative and regulatory framework generally parallels that of federally regulated financial institutions such as banks. Life insurance companies are largely regulated at the federal level (by OSFI) and the Insurance Company Act sets the same requirements as those faced by banks in terms of residential mortgage activities (mortgage insurance requirement, full disclosure of borrowing costs). The vast majority of trust and mortgage loan companies are federally regulated by OSFI, and the Trust and Loan Companies Act includes disclosure requirements. Finally, mortgage broker activities are regulated by provincial Mortgage Brokers Acts, which are largely consistent in terms of qualifications and the obligation of disclosure to borrowers.

The risk management practices of Canadian lenders are supervised by OSFI, which, in the context of its Supervisory Framework, provides assessment criteria for risk management. Both OSFI

and the Canada Deposit Insurance Corporation (CDIC) provide risk management guidelines in the context of their respective *Standards of sound business and financial practices*, which were improved at the end of the 1990s to align more closely with current concepts of, and operational framework for, risk management. Overall, the use of a transparent principles-based supervisory approach has been a source of strength for the Canadian financial system, since this approach more easily adapts to changes and is less open to arbitrage than rules-based supervision (Northcott, Paulin and White, 2009).

2.3.2. Regulation of mortgage products

The vast majority of mortgages in Canada are recourse loans, i.e., in the event of borrower default and foreclosure, the lender can pursue the borrower's other assets and income if proceeds from the foreclosure fall short of covering the value of the outstanding balance. This differs from the United States where, although not all mortgages are non-recourse, the non-recourse

nature of a significant proportion of mortgages is viewed as creating incentives for strategic defaults, thereby contributing to rising mortgage defaults when house prices decrease, further amplifying house price cycles.

Mortgage products are not directly regulated, other than for the minimum criteria for insured mortgages set by the government. However, legislation addresses a number of aspects related to mortgages, including interest (*Interest Act*) and disclosure requirements regarding the cost of borrowing (*Bank Act, Cost of Borrowing Regulation*).

In addition to abiding by regulatory requirements, financial institutions in Canada follow a number of voluntary codes of conduct. For instance, about a decade ago, the Canadian banking industry adopted a voluntary code of conduct regarding the use of plain language in mortgage documents (*Canadian Banker Association Commitment to Plain Language in Mortgage Documents*), in order to provide borrowers with mortgage documents that are easier to use and understand.^{12,13}

Table 1. Key characteristics of mortgage products

Amortisation	Typically 25 years; longer amortisation periods more popular over the past few years
Terms and rates	<ul style="list-style-type: none"> ■ Closed, open and convertible mortgages ■ Variable rate, fixed-rate or multi-rate mortgages ■ Six-month, one-, two-, three-, four-, five-, seven- and ten-year terms
Payment options	Monthly, biweekly, weekly and accelerated payment options.
Prepayment options	Prepayment provisions included in mortgage contracts vary among lenders. Examples: annual lump sum of up to 20% of the outstanding balance, or doubling-up of a monthly payment or increase in the periodic payment amount. Total prepayment of the mortgage before the end of the term is possible but generally subject to a penalty.
Portability and blend-and-extend options	Portability and blend-and-extend options allow consumers to avoid prepayment penalties when they move houses.

⁹ For private mortgage insurers, the guarantee covers the payment to the holders of mortgages they insure up to 90% of their net claims in the event of insolvency or liquidation of the mortgage insurer. There exists a ceiling for outstanding mortgages guaranteed by the government (approved by Parliament) and all recipients of the government guarantee are required to inform the Department of Finance of the amount of their insured guaranteed loans outstanding.

¹⁰ For instance, mortgage insurers require borrowers to satisfy specific debt service guidelines (i.e., their debt payments should not exceed a certain proportion of their income). Mortgage insurance premiums depend on the loan-to-value ratio, the nature of the mortgage (purchase or refinancing) and the borrower's source of income (employee versus self-employed), and a surcharge is added if the amortisation period exceeds 25 years.

¹¹ These criteria take various forms, for instance minimum credit score, minimum income documentation standards etc.

¹² http://www.cba.ca/contents/files/misc/vol_20040929_plainlanguagemortgagedocument_en.pdf
The Financial Consumer Agency of Canada (FCAC) monitors that financial institutions comply with their voluntary codes of conduct in addition to enforcing the federal laws that protect consumers in their dealings with financial institutions.

¹³ The use of plain language in documents pertaining to disclosure on mortgage agreements has been recommended for instance by the OECD (2009). In September 2009, the *Cost of Borrowing (Banks) Regulation* was amended, notably to include a requirement related to the use of plain language ("any disclosure required to be made by a bank under these Regulations must be made in language, and presented in a manner that is clear, simple and not misleading").

3. Key features of the Canadian mortgage market

3.1. Mortgage Products

The Canadian mortgage market is national, i.e., mortgage credit is accessible across the country on similar terms and conditions. The combination of macroeconomic developments (e.g., lower and less variable interest rates), advances in information technology, financial innovations, globalisation of capital markets and increased competition in the mortgage market over the past 10-15 years has resulted in greater choice for consumers in terms of mortgage products in Canada, as summarised in Table 1.

3.1.1. Amortisation and Term

The amortisation period and term of the mortgage have different durations in Canada, unlike the U.S. system where these two features coincide in the standard 30-year mortgage.

- The amortisation period is typically 25 years but the past few years have been characterised by the rising popularity of longer amortisation, notably as insured mortgages with longer amortisation periods became available. Nevertheless, there exist various prepayment options that allow borrowers to make accelerated payments which results in mortgages being effectively amortised over a shorter amortisation period.¹⁴
- 5-year mortgages were the norm up to the late 1990s-early 2000s and 5 years remain the most commonly used term in Canada (presently about 2/3 of outstanding mortgages have a 5-year term at the time of issuance). Nevertheless, a wide spectrum of terms has become available over the past few years, with terms ranging from 6 months to 10 years. Shorter terms have become more popular over the past few years, which can be explained, at least in part, by the declining interest rate environment in the early-mid 2000s.

The difference in the duration of the amortisation period and that of the term of the mortgage implies that, as the term of the mortgage expires, the borrower has to either pay off the outstanding

balance of the mortgage or renew his mortgage, i.e., opt into another term at a new interest rate. The latter process is repeated until completion of the full amortisation period. Opting into another term is the most widely used in practice. While borrowers used to stay with the same lender when their mortgage came up for renewal, the increase in competition over the past decade and a half has led more borrowers to shop around and switch lender if they can get more attractive conditions when their mortgage is due for renewal (thus meaning that in practice they pay off the outstanding balance to the former lender and enter a new contract with a new lender).

A combination of factors explains the widespread use of 5-year mortgages in Canada. Kiff (2009) suggests that on-balance sheet funding and deposit insurance interplay to explain this outcome. On the one hand, asset-liability management incentivises banks to align the term of mortgages they offer with the term of deposits used to fund these mortgages; on the other hand, the Canada Deposit Insurance Corporation (CDIC) guarantees retail term deposits with a term of 5 years at the maximum.¹⁵

3.1.2. Rate

While fixed-rate mortgages were the norm in Canada 10 to 15 years ago, variable-rate mortgages have become more popular as the low and stable inflation environment achieved with the adoption of a credible monetary policy framework contributed to a less variable interest rate environment. The rising popularity of variable rate mortgages was further boosted by the cyclical decline in interest rates in the early-mid 2000s. Survey data (CAAMP, 2010) suggest that about 2/3 of mortgage holders have a fixed-rate mortgage, versus slightly less than 1/3 with a variable-rate mortgage (and a limited proportion with a combination fixed-variable rate). By comparison, in 1999, less than 5% of residential mortgages were at a variable rate. There are nevertheless options for variable-rate mortgages that offer some protection to borrowers against interest rate risk. In some cases, an increase in interest rates does not translate into an increase in mortgage payments but rather in a change in the structure of these payments, i.e., a larger proportion of the payment is devoted

to interest payments while the share devoted to repayment of the principal decreases; while this limits the variability in mortgage payments for borrowers, it ultimately results in a higher outstanding balance at the term of the mortgage. In other cases, mortgage rates are capped, i.e., cannot increase above a certain predetermined value. Some variable-rate mortgages also come with an option to lock into a fixed-rate with no penalty at any time.

3.1.3. Prepayment

Contrary to the U.S. system, where borrowers can prepay their mortgage at any time without penalty, Canadian borrowers generally face potentially substantial penalties if they prepay the entire remaining balance on their mortgage.¹⁶ This contributes to explain the absence of “prepayment/refinancing waves” in Canada similar to those observed in the United States when interest rates are on a downward trend, such as in 2001-2002. However, as mentioned before, there exist prepayment options that provide borrowers with the flexibility to prepay part of their outstanding balance without facing a penalty.

3.1.4 Cost of mortgages: posted versus discount mortgage rates.

The entry of new competitors – virtual banks and mortgage brokers – in the Canadian mortgage market in the mid-1990s has led to changes in mortgage pricing. While these new competitors use an “everyday low price” strategy, major Canadian banks offer posted rates, which they discount on a customer-by-customer basis. Mortgage rate discounting by major banks has thus become standard practice, whereas discounting was limited and offered to only a minority of borrowers in the early 1990s (Bank of Canada, 2005.a; Allen and McVanel, 2009; Allen, Clark and Houde, 2010).

3.2. Players in the Canadian mortgage market

Various types of financial institutions (chartered banks, credit unions and caisses populaires, finance and non-deposit-taking companies, life insurance companies, pension funds and trust and mortgage loan companies), both domestic

¹⁴ Survey data (CAAMP 2010) suggest that over the 12-month period ending April 2010, about 25% of mortgage holders have taken advantage of prepayment options (lump-sum payments and/or accelerated regular payments).

¹⁵ The absence of insurance for deposits with a term beyond 5 years makes them much less attractive for depositors. Financial institutions must thus offer elevated interest rates on longer-term deposits to compensate for the risk. Higher funding costs at these terms translate into higher rates on mortgages with a term longer than 5 years, thereby limiting the attractiveness of longer-term mortgages for borrowers.

¹⁶ Kiff (2009) shows that, although there are no prepayment penalties in the United States, there are various fees associated with mortgage origination such that, ultimately, when these fees are taken into account, it is not necessarily less costly to prepay and refinance a mortgage in the United States than in Canada where there are direct prepayment penalties.

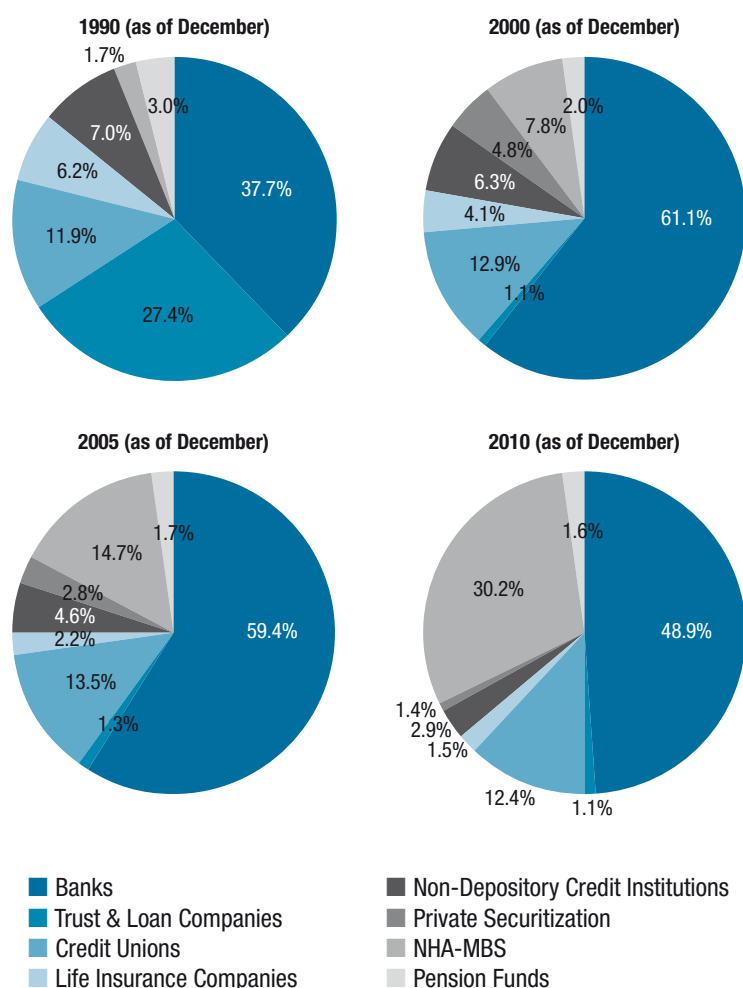
and foreign, provide mortgage credit in Canada. The market is nevertheless largely dominated by domestic lenders – the big banks in particular, whose market share has increased over time.^{17,18}

A key difference with the U.S. system is that mortgage lending in Canada, although provided by different types of lenders, is dominated by lenders that are subject to consistent regulations. Since the strong increase in mortgage lending by unregulated entities in the United States is one of the factors that supported the extension of mortgage credit to non-creditworthy borrowers, thereby ultimately contributing to the crisis, the predominance of regulated lenders in Canada has likely contributed to the resilience of the Canadian system.

Moreover, Canadian mortgage lenders tend to use prudent criteria to assess borrowers' creditworthiness and their ability to service their mortgage (e.g., income tests to assess borrowers' ability to service their debt, use of credit score, and use of higher interest rates than prevailing ones to qualify borrowers for variable rate and/or short-term mortgages in order to ensure they can face rising interest rates). There are two main incentives for lenders in Canada to ensure that the mortgages they originate are of good quality. First, a significant share of mortgages stays on banks' balance sheets (see Section 4), which differs markedly from the predominance of the originate-to-distribute model in the U.S. system, a factor widely accepted as having contributed to the crisis by removing the incentive for originators to promote high-quality loans (Mishkin, 2008). Second, high-ratio mortgages must abide by a number of creditworthiness minimum standards set by the government to be eligible to mortgage insurance.

Since mortgage brokers in the United States were a major source of subprime mortgage origination and played a role in the mortgage crisis (Berndt, Hollifield and Sandas, 2010), and since borrowers have increasingly relied on mortgage brokers in Canada,¹⁹ it is worth highlighting the differences between mortgage brokers in Canada and their U.S. counterparts. In Canada, mortgage brokers do not originate loans; they simply bring borrowers and lenders together. In most cases, the ultimate lender is one of the regulated financial institutions, thereby ensuring that the underwriting process used by brokers is the same as the one for mortgages directly

Figure 4 Residential mortgage outstanding balances by lender, snapshots



originated by those institutions. Moreover, in Canada, brokers have fiduciary duties, i.e., they negotiate rates on behalf of consumers, which is not the case in the United States where the compensation schemes do not create incentives for brokers to find borrowers the lowest rates (Hall and Woodward, 2010; Allen, Clark and Houde, 2010).

3.3. Subprime mortgage lending

Subprime mortgage lending in Canada was limited before the crisis and has become even more so recently. While subprime mortgage lending expanded in the first half of the 2000s, it never

accounted for a large share of the mortgage market (at their "peak" in 2006 subprime mortgages accounted for less than 5% of outstanding mortgages in Canada – compared to 14% in the United States). In addition to being much smaller than its U.S. counterpart, the Canadian subprime mortgage market was more conservative, both in terms of underwriting standards and products offered (Bank of Canada, 2005.b and 2007). Borrowers were "near-prime" rather than sub-prime, and none of the more extreme subprime mortgage products characterised by high delinquencies in the US (such as NINJA mortgages, Negative Amortisation, Interest Only mortgages) were offered in Canada. The more

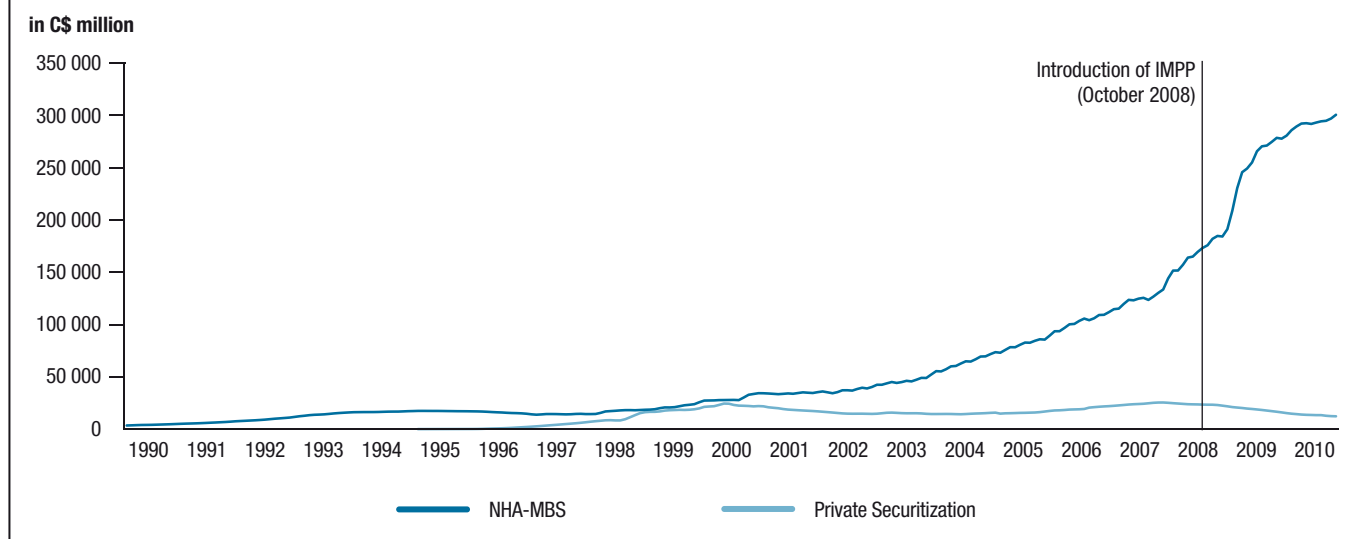
¹⁷ The big 6 Canadian banks account for close to 90% of total assets in the banking sector.

¹⁸ The increase in the share of mortgages provided by banks and the parallel decline in the share provided by trust and loan companies in the early- to mid-1990s result from the regulatory change in 1992 that permitted banks to acquire trust companies. This led to a wave of mergers whereby the six big Canadian banks acquired almost all the trust companies.

¹⁹ In 2009, 30% of new mortgages and 20% of renewed mortgages were obtained from a broker (CAAMP, 2010). By comparison, 26% of all home buyers reported using a mortgage broker in 2003 and 14% in 1999 (CMHC, 2004).

Figure 5

Mortgage Securitisation



conservative nature of the Canadian subprime mortgage market is illustrated by the fact that U.S. subprime delinquencies are about 10 times larger than subprime delinquencies in Canada (Figure 1). Subprime mortgage lending in Canada was provided by both regulated and unregulated lenders that were small, especially compared to prime lenders.²⁰

4. Funding of mortgages in the Canadian system

While securitisation is widely used in the United States, for both prime and subprime mortgages, on-balance sheet funding remains predominant in Canada, especially for prime mortgages. Deposit-taking institutions traditionally rely on Guaranteed Investment Certificates (GICs) and other similar interest bearing term instruments sold to savers to fund mortgage loans. By maintaining intact the incentive for mortgage lenders to adopt prudent underwriting criteria consistent with ongoing performance of the loan, on-balance sheet funding contributed to the resilience of the Canadian system. Allen, Clark and Houde (2010) relate this lesser use of securitisation to the prevalence of shorter term mortgages in Canada. In contrast, the maturity mismatch between 30-year mortgages and short-term deposits in the United States spurred the expansion of securitisation, thus obtaining a source of long-term funding that better matches the term of the mortgage.²¹

However, mortgage securitisation has expanded over the past 2 decades (Figure 5), largely under the impetus of two government initiatives aiming to improve the availability of low-cost funding for mortgages through the development of active secondary markets: the NHA-MBS program, introduced in 1987, and the Canada Mortgage Bond (CMB) program, introduced in 2001.

NHA-MBS are mortgage-backed securities created from pools of amortised residential mortgages insured under the National Housing Act. A key feature of NHA-MBS is that they benefit from an explicit government guarantee, as opposed to the implicit guarantee associated with MBS issued by the U.S. GSEs. There is in fact a double layer of government protection. First, the mortgages underlying the MBS are insured mortgages and are thus guaranteed by the government against the risk of borrower default. Secondly, the NHA-MBS benefit from a full guarantee by CMHC (on behalf of the government) of timely payment of interest and principal, thereby protecting MBS investors against the risk of default of the financial institution that issued the NHA-MBS. The NHA-MBS program has evolved over time, notably to reflect underlying changes in the mortgage market. For example, as the popularity of variable rate mortgages increased over time, NHA-MBS backed by variable rate mortgages have become available.

The resilience of the Canadian housing finance system despite the increased use of securitisation can be explained by differences related to screening criteria and incentives in the securitisation process compared to the United States. The misalignment of incentives among participants in the U.S. securitisation process has been identified as a factor that contributed to the crisis (Paligorova, 2009; Keys, Mukherjee, Seru and Vig, 2009). The NHA-MBS program has requirements that avoid such misalignments. First, NHA-MBS issuers are responsible for servicing the mortgages in the mortgage pool backing the MBS. Secondly, there are strict criteria regarding the institutions allowed to issue NHA-MBS. NHA-MBS issuers must be federally or provincially regulated institutions. Moreover, NHA-MBS issuers must be approved by CMHC. This approval process is based on criteria set by CMHC and provides another layer of scrutiny regarding the soundness and risk management of the issuing institutions, beyond the fact that those institutions are subject to effective supervision by relevant federal and provincial authorities. The approval of NHA-MBS issuers by the same agency as that which provides the guarantee on NHA-MBS mitigates the potential for moral hazard.

The Canada Mortgage Bond (CMB) program has further contributed to the increase in mortgage securitisation in Canada by expanding the investor base for financial market products backed

²⁰ For instance, total assets under administration at Xceed Mortgage Corporation, one of the largest players in this market segment, reached a maximum of less than \$3,000 million in 2007 and have since declined to less than \$1,800 million as of April 2010. This compares to \$436,023,410 million and \$465,935,651 million for total residential mortgages at the big 6 banks for the same dates respectively.

²¹ Other factors are often cited to explain the predominance of securitization in the U.S. system, including the existence of the Community Reinvestment Act and the accounting treatment of securitization (upfront recognition of profits).

by mortgages. Under the CMB program, the Canadian Housing Trust (CHT) transforms the monthly cash flows from NHA-MBS into non-amortising bond cash flows with fixed interest payments and principal payment at maturity, thereby providing investors with a bond-like investment.²² CMHC guarantees, on behalf of the government, the timely payment of interest and principal on CMB to investors.

NHA-MBS have been accounting for an increasing proportion of total residential mortgages outstanding, rising from less than 2% in 1990 to about 20% prior to the crisis (Figure 4). The strong increase in NHA-MBS from late 2008 to early 2010 is the result of the Insured Mortgages Purchase Program (IMPP), a temporary program created during the crisis under which the federal government purchases NHA-MBS from Canadian financial institutions in order to ease funding pressures for lenders.²³ Private securitisation, i.e., non NHA-MBS, was more widely used for subprime mortgages than for prime mortgages. Given the limited size of the Canadian subprime mortgage market, private securitisation is thus extremely limited in Canada, even more so since the crisis (Figure 5).²⁴

5. Recent developments in the Canadian housing finance system

5.1. Innovations prior to the financial crisis

The Canadian housing finance system did not experience the excesses of its U.S. counterpart, in part as a result of the features identified in this paper (e.g., regulatory and supervisory framework, better incentives alignment associated with funding). However, there were innovations in the Canadian system in the early-mid 2000s which contributed to mortgage credit expansion, including lending to borrowers who were previously unable to get mortgages, a trend also observed in other industrialised countries (CGFS, 2006). The first type of innovation relates to subprime mortgage lending which, as described in Section 2.3, remained limited and relatively conservative. The bulk of innovation in the Canadian mortgage system actually occurred in the mortgage insurance market. Innovations

in the mortgage insurance market took mostly three forms: (i) introduction of mortgage insurance products targeted at borrowers who could not previously qualify for insured mortgages (e.g., self-employed people, Alt-A borrowers); (ii) introduction of extended amortisation period (up to 40 years); and (iii) increased loan-to-value ratio (up to 100%). These innovations in mortgage insurance, as they give access to prime (insured) mortgages to borrowers previously not eligible, can contribute to explain the limited expansion of subprime lending in Canada compared to the United States. Since the risks associated with these innovative insured mortgages are higher than those associated with more “traditional” insured mortgages, mortgage insurers adjusted their risk management framework accordingly: first by applying tighter underwriting standards for those new products (e.g., higher qualifying credit score, higher down payment for Alt-A borrowers) and second by charging higher insurance premiums for these products. This differs from the United States where the wave of innovative mortgage products (mostly in the subprime segment) was generally not accompanied by such a prudent approach in terms of risk management.

5.2. Impact of the financial crisis on the Canadian housing finance system

Although the Canadian mortgage and housing markets have been resilient during the crisis, the crisis has had an impact on the Canadian housing finance system.

The first impact was direct. As global securitisation markets froze, subprime lenders in Canada faced funding challenges despite the fact that the subprime market in Canada did not deteriorate to the same extent as in the United States (Figure 1). This led to a decline in subprime mortgage lending as a number of subprime lenders left the market altogether while others changed their business models, mostly to concentrate on prime mortgage lending.

The second impact is an indirect one, taking the form of “lessons learned.” As the U.S. housing crisis unfolded, the Canadian government adopted a pre-emptive approach in adjusting the mortgage insurance framework— the key levy authorities

can manipulate to influence the housing finance system – so as to ensure that developments in the housing market would not cause instability and to support healthy and stable growth in the housing market in the longer term.

The first adjustments were announced in October 2008 and included: (i) a decrease in the maximum LTV ratio for insured mortgages from 100% to 95%; (ii) a shortening in the maximal amortisation period to 35 years (from 40 years); (iii) the adoption of a consistent minimum credit score requirement (the industry was already using minimum requirements but there were no standards ensuring consistency); and (iv) the introduction of minimum loan documentation standards.

The second round of adjustments was announced in February 2010. First, to ensure that borrowers would be able to face rising interest rates in the future, they have to be able to qualify at a 5-year posted fixed mortgage rate even if they choose a shorter term and/or a variable-rate mortgage.²⁵ Second, the maximum refinancing amount for government-backed insured mortgages was reduced from 95 to 90%. Finally, in order to discourage speculation, a 20% down payment is required for government-backed mortgages on non-owner occupied properties (compared to 5% previously).

6. Conclusion

A number of features of the Canadian housing finance system explain its resiliency during the recent crisis, especially compared to the U.S. system. The existing supervisory and regulatory framework, which applies in a consistent manner to almost all mortgage lenders in Canada, supports sound risk management practices. A better alignment of incentives for mortgage originators contributes to maintaining stricter underwriting standards, thereby ensuring that the mortgages they originate are of good quality, whether these mortgages are funded on- or off-balance sheet. Mortgage insurance and mortgage securitisation are subject to regulatory criteria that mitigate the potential for moral hazard associated from the explicit government guarantee on insured mortgages and securitised products backed by these mortgages. In particular, issuers of NHA-MBS must comply with a set of criteria regarding soundness and risk management practices.

²² The CHT, a special purpose entity created and managed by CMHC, sells non-amortizing CMBs and uses the proceeds to purchase newly issued NHA-MBS.

²³ When the program was terminated at the end of March 2010, \$69 billion of NHA-MBS had been purchased (out of a \$125 billion maximum size announced).

²⁴ Some subprime lenders in Canada also relied on the third-party (i.e., non-bank-sponsored) ABCP market to fund their mortgages and were thus exposed to rollover risk. When the third-party ABCP market came to a freeze in August 2007, these lenders faced significant funding difficulties which led some lenders to leave the market altogether and others to change their business models away from subprime mortgage lending.

²⁵ Previously the standard was to use the 3-year fixed rate.

As the mortgage insurance market evolved, with innovative products that support access to mortgage lending, the regulatory framework has been adjusted so that the underlying riskiness of mortgage insurance products is subject to appropriate risk management controls. Overall, sound underwriting criteria and appropriate oversight have contributed to the resilience of the Canadian housing finance system.

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Flexibility, Security and Efficiency of Security Rights over Real Property in Europe

↳ By Dr. Otmar Stöcker

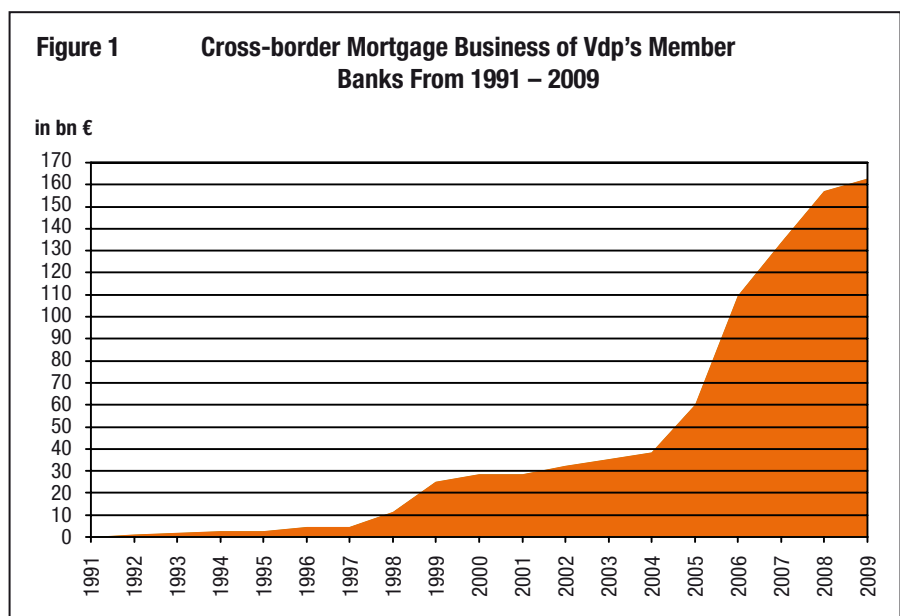
1. Need for comparative law information

Comparative law accounts of the law on security rights over real property in Europe are rare. Some detailed investigations are targeted at dealing with considerations concerning a Eurohypotheck and for this purpose describe only a few mortgage law systems. The studies by the European Mortgage Federation overwhelmingly offer only a superficial overview or merely address some individual aspects in more detailed form. Other works apply only to individual countries or provide a broad picture in the context of a description of the law of property in the form of national reports.

The need for studies into mortgage law is, however, more urgent than ever.

1.1 Business

In recent years the need for reports on the law of mortgages covering several countries or even covering all of Europe has sharply increased. The reasons for this lie partly in the increasing cross-border mortgage business in Europe, which can be seen with the respective volume of vdp's member banks (see chart), which developed from 55,6 million. (1991) to 163 billion Euro (2009). The result of this is that a growing number of people are having to deal with the associated legal questions and the need for getting up to speed quickly with a different legal system is growing. Comparative reports and overviews make this easier. In addition, the involvement of foreign legal systems in the credit process and, moreover, particularly in risk management, inevitably results in individual credit institutions having to develop



assessment procedures in order to evaluate the different regulations. Banking groups that operate on a pan-European basis also have to deal with the legal systems of several countries in relation to risk management and group-wide risk weighting rules.

1.2 Demand because of risk weighting under the requirements of banking law

Stable credit institutions are an essential prerequisite for a functioning national economy and for a modern national economic system. Both the individual state and the international community therefore have a great interest in the stability of

the banking system. Consequently, individual states and supranational organisations develop statutory regulations or other sets of rules that are intended to ensure the stability of the banking industry. An important cornerstone is a system of banking supervision with a risk-sensitive focus. Particularly important in this regard is the fixing of limits up to which banks are permitted to undertake risks. In relation to loans, the risk profile is dependent, among other things, on the type and soundness of the loan collateral, and in relation to property loans, particularly on the quality of security rights over real property.

Of key importance for banks in Europe is how Basel II has been implemented in European law and then in national law. The relevant EU Capital Requirements Directive² specifies in Annex VI

The latest data on a country by country basis is shown in Association of German Pfandbrief Banks, Annual Report 2009, p. 34.

² Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions, Official Journal of the European Union of 30.6.2006, L 177/1 et seq.

Number 48. c) and Number 54. c), in each case in conjunction with Annex VIII Part 2 Number 8³ that a reduction of capital requirements on the basis of real estate collateral is only possible if the mortgage is enforceable and this enforceability has been legally verified. In addition the credit institution must be in a position to be able to realise the value of the mortgage within a reasonable period of time. These requirements apply both in relation to the standardised approach and the internal ratings-based approach.

For banks that operate in several countries, and all the more so for international banking groups, this means that loan collateral must undergo a risk analysis that they use to mitigate risk and thereby reduce capital backing. In order to bring real estate collateral into one uniform risk assessment system, an evaluation system that could be used to assess loan collateral on a transnational basis would seem to be desirable.

An assessment system for mortgages has not yet been publicly discussed. Solely, in 2005 the rating agency Moody's issued what was merely an overview in which it estimated the recovery rates for several European countries ("key jurisdictions"), largely on the basis of a short analysis of the legal framework and rather less on the basis of statistical data, such data being then (and now) not sufficiently available.⁴ The resulting classification is very simplified but it does, however, at least show the usefulness of a qualitative comparative law analysis, particularly if statistical data is lacking. These findings should be taken into account in further deliberations concerning a legal assessment system.

Against this background, it was important for HypRating⁵, having offered to their customers recovery rates for Germany since 2002, to find solutions for foreign countries. Although HypRating was able to appraise recovery rates for several countries based on statistical data, it will take a long time to draft a full picture over recovery rates in all relevant countries. This is why HypRating has made the findings of the Round Table⁶ the base of their considerations to assess recovery rates founded on comparative law.

1.3 Crisis

Since the crisis in financial markets triggered by the subprime mortgage crisis, if not earlier, the degree of transparency required of structures within the capital and banking markets has generally increased. Professionals who deal with several legal systems in the course of their international mortgage business have, time and again, articulated their need for clearly set out descriptions of the law of property.

Sometimes astonishing and even shocking news was spread worldwide on how enforcement of mortgages is performed – and no information, at least none easy to understand, was available to show legal and practical facts of the relevant country in comparison to others.

1.4 Legislation

For several years in many countries, primarily in Central and Eastern Europe, the civil law systems as a whole have been subjected to scrutiny and have undergone far-reaching modernisation; mortgages figure highly here and the experts involved are very interested in transnational exchanges of opinion and experience. In Western Europe too the law of security rights over real property has been amended and supplemented in many countries, e.g. by the introduction of the "hypothèque pour toutes sommes" in Belgium (1996)⁷, the "hypothèque rechargeable" in France (2007)⁸ and by expansion of the scope of application of the "hipoteca de máximo" in Spain (2007)⁹. All three changes have been in the direction of greater flexibility in countries in which mortgages had hitherto been among the least flexible.

The White Paper on Mortgage Credit aims to increase the efficiency of mortgage markets. To this end it also deals with the duration of land registration and compulsory enforcement proceedings.¹⁰ Protection of the owner or consumer in enforcement proceedings is not taken into consideration. This is all the more astonishing as the White Paper in other respects prioritises consumer protection issues. In the meantime, based on the White Paper, in 2008 the EU Commission

began to prepare a Recommendation on real estate valuation, enforcement proceedings and registration. Influenced by the impact of the financial crisis, the EU Commission postponed the publication of its recommendation, thus changing its course increasingly considering aspects of debtor protection. In this context the EU Commission is now working on a report on measures to hinder enforcement proceedings. This narrow perspective, putting emphasis on debtors' interest only, does not seem to be adequate to deal with the complex legal issues of debtor and owner protection with mortgage loans.

Furthermore works have started to put all responsibility of any problem with mortgage loans on the shoulders of the creditor via introducing regulations on "responsible lending".

2. Round Table on flexibility of mortgages

The vdp has set itself the goal of contributing to transparency in the law on mortgages in Europe, not only in the form of publications relating to specific countries, but also by developing transnational slides that facilitate rapid access to detailed information and legal facts. It was for this purpose that the so-called "Round Table: Flexibility of security rights over real property in Europe" was established, in which mortgage collateral specialists from 24 countries are now involved.¹¹ Since 2005, 8 workshops have taken place, each one lasting 2 full days.

The aim of the Round Table is to provide legal information in form of country charts in colour showing Europe (and Japan) as an overview and answering questions in an easy-to-understand way. The whole series of slides was first published in 2009 – in German¹² and in English translation.¹³ Alongside their function as an information source, publications also have important significance for the credibility of an assertion or an analysis because they are open to review by a specialist audience, unlike secret legal opinions about complex capital market instruments, which cannot be the subject of broad, academic review.

³ Capital Requirements Directive, Annex VIII Part 2 Number 8: "For the recognition of real estate collateral the following conditions shall be met: a) Legal certainty – The mortgage or charge shall be enforceable in all jurisdictions that are relevant at the time of the conclusion of the credit agreement, and the mortgage or charge shall be properly filed on a timely basis. The arrangements shall reflect a perfected lien (i.e. all legal requirements for establishing the pledge shall have been fulfilled). The protection agreement and the process underpinning it shall enable the credit institution to realise the value of the protection within a reasonable time frame. b) Monitoring of property values..."

⁴ Cf. Moody's European Country Tiering for CMBS Recovery Rate Assumptions: Focus on Key Jurisdictions.

⁵ Hyp Real Estate Rating Services GmbH is a subsidiary of Verband deutscher Pfandbriefbanken e.V.

⁶ See section 2.

⁷ See Stöcker/Stürmer, Flexibility, Security and Efficiency of Security Rights Over Real Property in Europe, Volume III, 2nd revised and extended edition, Berlin 2010 (vdp's publication series, Volume 39), p. 48.

⁸ See Gourio, L'hypothèque rechargeable, Revue de droit bancaire et financier, No 9/10 2006, pp. 39; Stöcker/Stürmer, Flexibility, Security and Efficiency of Security Rights Over Real Property in Europe, Volume III, 2nd revised and extended edition, Berlin 2010 (vdp's publication series, Volume 39), p. 23.

⁹ The Spanish hipoteca de máximo is examined in a thesis by Hector Simón Moreno on the harmonisation of mortgage law in Europe, which will be published in the near future.

¹⁰ European Commission, White Paper on the Integration of EU Mortgage Credit Markets, Brussels, 18.12.2007, 4.2.

¹¹ 13 national reports and a series of comparative law slides by authors from this expert group have already been published in volumes 23 and 32 of the vdp's publication series.

¹² Stöcker/Stürmer, Flexibilität, Sicherheit und Effizienz der Grundpfandrechte in Europa, Band III, Berlin 2008 (vdp's publication series, Volume 37).

¹³ Stöcker/Stürmer, Flexibility, Security and Efficiency of Security Rights Over Real Property in Europe, Volume III, Berlin 2009 (vdp's publication series, Volume 39).

The first edition (volume 37/39) contained a substantial series of slides, displaying a comparative description of the law of security rights over real property for 22 jurisdictions with explanations of the individual questions and answers. On this basis, in two additional workshops of the Round Table in March and November 2009 in Berlin, an assessment process could be developed, generally and for specific business perspectives. This process and its results are published in volume 43 (in German)¹⁴ and 44 (in English)¹⁵. In this second edition the number of analysed jurisdictions increases to 24. The Vdp is prepared to foster materially scholarly-based development of such evaluation procedures also in future. For this, co-operation with scholars in Sweden and other European countries was initiated with the objective to integrate more jurisdictions into the work of the Round Table.

3. Methodology

Procedures for assessing legal structures require, in the first place, a detailed description of the different legal systems in accordance with a standard base model. To develop this is a major challenge.

On the one hand, the questions asked must be worded so generally that they are meaningful for all the legal systems involved. On the other hand, the degree of detailed analysis must be as high as possible in order that the strengths and weaknesses of the individual legal systems can be truly understood – and all the while taking careful account of the framework conditions of individual business models or types of business. Thus, different legal questions are to some extent relevant in the case of private housing finance than in the case in relation to commercial property loans.

3.1 Charts on questions & answers

The commentary on the slides about the law of mortgages is divided into seven subject areas.

Following some basic remarks on types of mortgages (I.), central issues regarding register systems, and how they bring about the requirements of public disclosure for mortgages, are addressed (II.).

The discussion of the effects of accessoriness (III.) draws as many distinctions as possible in order to counteract the normally encountered

black and white classification into accessory and non-accessory mortgages which frequently leads to misconceptions, particularly in regard to protection of the owner. A separate chapter is therefore devoted to this issue (IV.), which is, incidentally, of the greatest importance, not only for consumers, but also generally, for every owner of mortgaged property, and it is therefore dealt with comprehensively, the consumer aspect included.

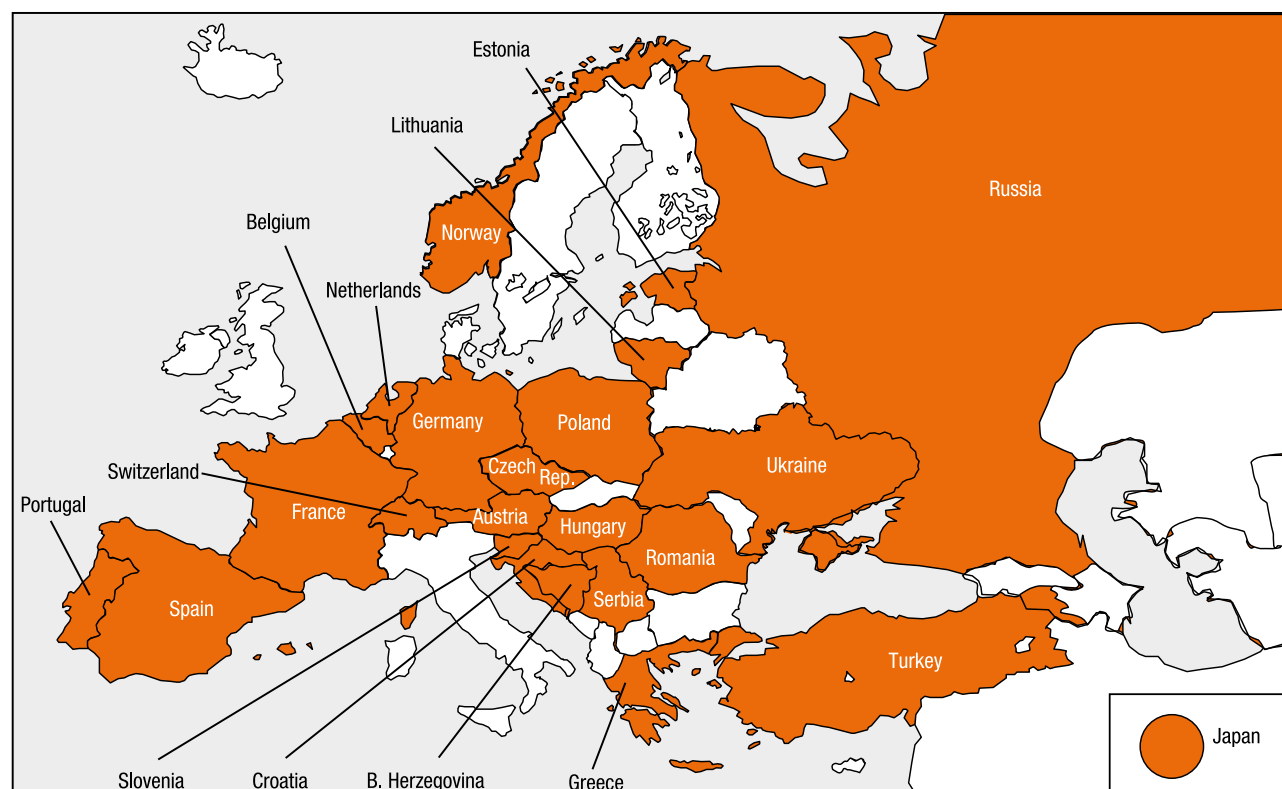
Security rights over real property are used to secure payment debts and they must prove their worth if the debtor is no longer able to pay. The “legal solidity” of a mortgage in the context of enforcement proceedings (V.) and insolvency proceedings (VI.) is thus of key importance for credit practice. The numerous slides dealing with these issues take account of this.

The questions covering the subject areas mentioned above, which are of practical importance but still geared towards legal theory, are supplemented with a chapter dealing with the practical application of mortgages (VII.) in some important business cases.

Figure 2

Vdp – Round Table on Rights Over Real Property

Participating Countries



¹⁴ Stöcker/Stürmer, Flexibilität, Sicherheit und Effizienz der Grundpfandrechte in Europa, Band III, 2. erweiterte Auflage, Berlin 2008 (vdp's publication series, Volume 43)

¹⁵ Stöcker/Stürmer, Flexibility, Security and Efficiency of Security Rights Over Real Property in Europe, Volume III, 2nd revised and extended edition, Berlin 2010 (vdp's publication series, Volume 44).

The work of the Round Table, even at this stage, has already attracted the attention of banking practice, as documented by the use of the results by HypRating. Also academics are beginning to discuss the issues of the Round Table.

3.2 Assessment system for mortgages

Another focus of the study is put on a more detailed description of a possible assessment system for the legal framework for mortgages in Continental Europe. It is intended to offer an initial overview as to how the “legal soundness” of security rights over real property could be comparatively “measured” in a general or a bank-specific manner, or in accordance with the particular type of business. It does, however, not claim to be a fully developed econometric international comparison.

Volume 43/44 does not only document the approach to the development of the assessment system, but also the details of the weighting and assessment ratios as well as the results of the assessment in form of bar graphs.

3.2.1. Assessment procedure

The various slides contain many questions on many countries. In order to reach a comparative law conclusion, in the sense of an assessment, it was beneficial to generate a rating score per country at the end of the assessment process.

To achieve this, the legal conclusions of the slides had to be brought into a points system. For this purpose the various answers from the individual slides had to be weighted, and also the individual questions in relation to each other.

The weighting of the questions were geared to the significance of a question for the overall assessment, so according to how important the individual question is based on a balanced consideration of the various interests that have to be taken into account (bank risk, cost of credit, consumer and owner protection etc.). The weighting of the answers to any one question depended on how good or bad the outcome of the individual answers were; this in turn also had to be judged on the basis of various interests.

Questions and answers that are judged to be neutral or of the same value were given a weighting of 0 or receive the same number of points. They were not, however, removed from the series of slides as they could be extremely important for understanding the legal interconnections.

In the final stage the weighted scores per country were added together to produce the rating

score and this was then compared with the rating scores of the other countries.

Processes of this type to quantify quality are presently very common in many areas for establishing rankings. If the process is carried out with the maximum care and diversified weighting, useful conclusions are reasonably possible. Such findings should not, however, be rendered in absolute terms; the quantification of quality has too many fundamental weaknesses for that. When making decisions about taking on financing, it is above all advisable to avoid a rigid schematic approach without pragmatic reconsideration of the details of the individual case.

3.2.2 Importance of business model and business structure

Abstract theoretical judgments about the “mortgage law” of a country are problematic for the purpose of risk assessment by banks as all legal systems permit many versions of security by mortgage, and most of them also have available several types of security right over real property. Thus any simplification inevitably leads to a gross distortion.

A more targeted approach is to examine the security quality of mortgages in terms of the specific security quality of business models and specific business structures, because the particular features of these have consequences for the contract and collateral structure. These business models may be different with every bank. Using these business models, the slides are then chosen that are actually relevant in the individual case, and this applies likewise for the individual answers to the various slides.

This institution-specific approach corresponds to the objectives of Basel II which aims to achieve high quality supervision that is specifically geared to the specific business structures of a bank. An assessment system for mortgages conforming to this directional approach is much more telling for the risk situation of security rights over real property that are actually used by a bank than an abstract, theoretical cross-section appraisal of many countries that by its nature must remain imprecise and superficial.

Example: in relation to commercial property financing via SPVs

- preferential rights for employees are not relevant, but are very relevant in relation to direct company financing and in particular in relation to working capital finance;
- preferential rights for persons entitled to alimonies can be disregarded, but not in relation to residential financing.

Thus, in relation to the business model for commercial property financing via SPVs, preferential rights of these types may also be left out of consideration in countries that in principle recognise such rights in enforcement and insolvency.

3.2.3 Different perspectives

Alongside the evaluation of mortgages from the point of view of banks, i.e. mortgage creditors, other perspectives should, however, also be taken into consideration, namely the perspective of the debtor/owner whose protection against unjustified enforcement proceedings merits attention and the perspective of the legislature, which has to create a balanced overall system and to do this has to set priorities.

Evaluation of the legal quality of security rights over real property from these different perspectives sometimes leads to questioning of different priorities than if matters are considered solely from the point of view of a bank. But even for a bank the questions differ in significance depending on whether it only examines the prospects of realising a mortgage that already exists or whether it also wishes to evaluate the extent to which a security right over real property can and is to be used to secure a credit structure that is capable of being established in the market. For an overall complete assessment, political stability of the legal system may be of much significance, too.

In its advisory role the vdp has for a long time recommended that a balanced overall system should be the objective because it is only in this way that a long-term stable legal framework can be established. Regulations that strongly and unilaterally favour the mortgagee run the risk of being corrected sooner or later by case law or legislation. They are, at the end of the day, also unsuitable for safeguarding long-term market opportunities.

4. Findings of the Round Table in cooperation with HypRating

The results obtained to date have shown that in many countries where mortgages have an accessory structure. The type of security right primarily used is the maximum amount hypothec; here the accessoriness of scope is relaxed, because the secured claim can fluctuate in terms of amount without need to change the amount of the security right over real property. This has, to some extent, a very high level of flexibility, but only as long as the owner and creditor do not change. An in-depth academic reappraisal of mortgages in Europe from a comparative law perspective will not be completed for a long time yet. There is a great need for comparative law investigations

into the structural linking of loan agreement and creation of the mortgage, the issue of allocation of the burden of proof, as well as acquisition in good faith and the use of unconditional promises of payment. The financial crisis confirmed the previously initiated strategy to add special chapters covering enforcement law and insolvency law.

The attachment, published in volume 43/44, gives detailed description of the findings of the Round Table in the two workshops of March and November 2009.

On the one hand, the Round Table could agree on weighting ratios to each question and answer, thereby evaluating each question and answer from four different perspectives:

- perspective of a bank, who has to exploit a security right over real property (bank / enforcement),
- perspective of a bank, using a security right over real property to secure loans (bank / usability),
- perspective of an owner facing enforcement of his real property (owner) and
- perspective of a legislator, who wants to consider diverging interests of all parties adequately (legislator).

On the other hand, findings are published, which are derived from the combination of those weighting ratios with the individual country information. For this, in a first step all 89 questions are considered for calculation. This results in the following categories of findings:

- Complete findings – perspective of enforcement
- Complete findings – perspective of usability
- Complete findings – perspective of the owner
- Complete findings – perspective of the legislator
- Complete findings – total addition of all scores (see Figure 3)

In a second step, only the questions of the chapters VI. and VII. are considered in order to limit the analysis to problems of enforcement and insolvency law; issues of flexibility of the security rights over real property are not taken into consideration in this version of the findings in order to prevent possible criticism that the complete results would favour non-accessory security rights over real property. This leads to the following categories of findings:

- Partial findings enforcement and insolvency – perspective of enforcement
- Partial findings enforcement and insolvency – perspective of usability
- Partial findings enforcement and insolvency – perspective of the owner
- Partial findings enforcement and insolvency – perspective of the legislator

- Partial findings enforcement and insolvency – total addition of all scores (see Figure 4)

The publication of all these details is designed to make the method and performance of the analysis more comprehensible. However, it would be beyond the limits of the book to give a detailed full description of the intense discussions of the Round Table and the reflections that resulted in the particular assessment of each ratio.

The technical calculation of the results was done by HypRating. It turned out that HypRating can use the findings of the Round Table very well, because this assessment system grants a high grade of

transparency and is updated regularly. Moreover, its extension to further countries is possible.

Hard copies of the vdp publication series including the book presented here can be obtained free of charge from the vdp via the order centre on vdp's website. As soon as hard copies are out of print, the publication will be made accessible via downloading from vdp's website.

Figure 3 Complete Findings – Total Addition of all Scores

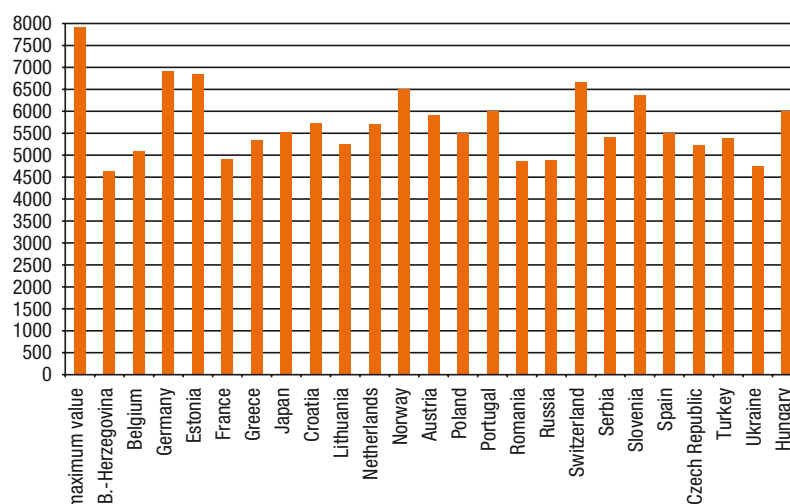
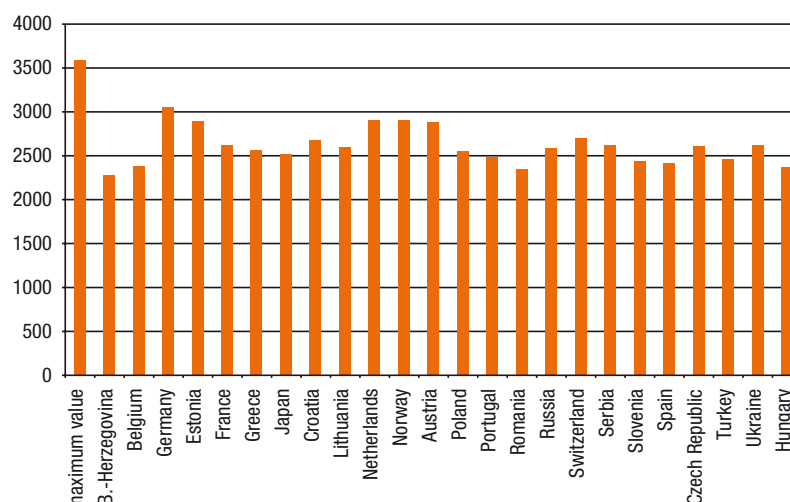


Figure 4 Partial Findings Enforcement and Insolvency – Total Addition of all Scores



¹⁶ http://www.pfandbrief.de/cms/_internet.nsf/index/en_66.htm

The Role of Mortgage Securitisation in The Financial Crisis and How to Restore The Market's Health

↪ By Rob Thomas

This paper examines the role of mortgage securitisation in the financial crisis and the way that policymakers responded. It then puts forward a preferred approach to restoring a healthy Residential Mortgage Backed Securities (RMBS) market.

1. A critique of securitisation

To many commentators and some regulators, the securitisation market was at the very heart of the financial crisis and played a pivotal role in bringing it about. The narrative they subscribe to reads something like this: The securitisation market allowed an 'originate and distribute' business model to develop, where the lender retained little or no interest in the on-going performance of the loans it made. As a result, these lenders were not incentivised to care about the quality of their lending, and they allowed standards to fall. For example, The Turner Review of March 2009 said 'the development of securitised credit has ended up producing the worst financial crisis for a century'.

Moreover, it is claimed that there was a lack of transparency, creating an asymmetry of information between loan originator and buyer, which allowed the seller to pass off pools of poor quality loans to buyers who were unable to gauge their real quality. This meant that investors were taking much higher risks than they realised.

How fair is this narrative? Well, there is an alternative way of presenting these events that is a mirror image of these arguments: Declining interest rates from the mid 1990s onwards encouraged investors to seek higher returns by taking higher risk in a 'search for yield'.

As the advanced economies continued to perform well year after year, investors became more and more relaxed about risk. At the same time, rising

savings rates in emerging economies such as China was recycled into the advanced economies, increasing global liquidity and driving up demand for financial assets across the board.

Lenders responded to these market signals – higher investor demand, especially for higher yielding higher risk assets – as any supplier in a competitive market economy is supposed to: They increased lending to end borrowers (both consumers and firms), driving down the cost, especially for higher risk, higher yielding lending such as sub-prime.

By juxtaposing these two explanations of the causes behind the US sub-prime crisis, it is clear that the argument that 'originate and distribute' lenders and the securitisation market were responsible cannot be seen as a fair representation of the event.

As in previous upswings, perceptions of risk by market participants, including borrowers, lenders and investors, became distorted by years of benign market conditions and rising asset prices.

And had the US sub-prime market not existed, excess liquidity would have been recycled through some other market, just as the recycling of Middle Eastern funds in the early 1980s fuelled the over-borrowing that led to the emerging market debt crisis, with banks rather than securitisation acting as the transmission mechanism on that occasion.

2. Issue of transparency and asymmetry of information

In their critique of securitisation, regulators have focused on the issue of transparency above all others and, in the case of the European Commission, have sought industry initiatives to improve trans-

parency under pain of harsher regulatory treatment should the industry fail to deliver.

Yet an assessment of the transparency of securitisation relative to other funding instruments such as unsecured bonds issued by banks or other corporates shows that the degree of transparency – the extent to which the investor can see and understand what they are investing in – is unambiguously superior with a securitisation.

A securitisation relies on a defined pool of assets. The level of information available to the RMBS investor varies depending on the nature of the transaction. Typically, in RMBS backed by non-conforming or sub-prime mortgages, investors receive loan-by-loan information while in UK master trust transactions, which typically contain hundreds of thousands of individual prime mortgages, aggregated pool data is provided as loan-by-loan data is of limited value over such large portfolios. But typically all deals, as a minimum, show average initial loan-to-value (LTV) ratios, loan-to-income (LTI) ratios and details about borrower type.

By comparison, an investor in an unsecured bank bond has much less visibility of the assets and activities of the bank they are lending money to. And the same is true with any corporate borrower, which is free to change the risk profile of its business over time, and involve itself in a range of activities, the riskiness of which is hard to judge from outside.

Stemming from the concern about transparency is the belief that the securitisation market suffers from an asymmetry of information between issuer and investor. The critique has it that the RMBS seller, being in possession of information that the buyer is not party to, can dupe the buyer into believing that the quality of the bonds they are investing in is higher than it really is¹.

¹ For example the Bank of England's consultative paper 'Extending eligible collateral in the Discount Window Facility and information transparency for asset-backed securitisations' of March 2010 states that there is an information asymmetry between the buyer and seller of asset backed securities.

But again, a comparison with other markets is instructive.

In any financial transaction there is the potential for an asymmetry of information. The seller will invariably have better information about what they are selling than the buyer, and history is littered with examples of asymmetries of information in financial transactions that led to catastrophic losses for investors, for example with Enron.

Moreover, any seller in a financial transaction will always want to give the best impression, whether it is a company selling its equity or bonds or a country funding its deficit.

But, the more transparency the investor has, the less potential there is for an asymmetry of information. And, as mentioned above, RMBS are amongst the most transparent of financial instruments.

Consider an investor buying US sub-prime RMBS in 2006. These investors were funding sub-prime mortgages (the term sub-prime was something of a clue as to the quality of the borrowers) secured on property values that had enjoyed extraordinary gains in the preceding 5 years as can be seen from Figure 7.

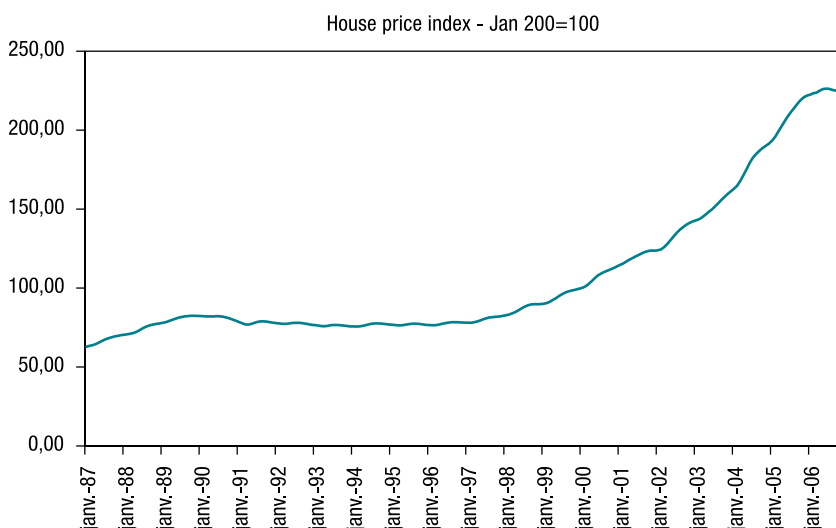
Were these investors the victims of lenders with hidden information on the poor quality of their lending? Or did they ignore the warning of excessive house price growth and loose lending criteria. Indeed, it is hard to argue that the lending process was in any meaningful sense secret when investors were free to see the types of business being accepted by US mortgage brokers and see the products available in the market.

Furthermore, securitised mortgage portfolios are subject to significantly more transparency than portfolios on lenders' balance sheets, as the securitisation process requires external scrutiny of lending processes and standards by rating agencies and on-going reporting to investors.

Clearly, events in the US sub-prime market demonstrate that this additional transparency is no protection against losses when all the parties involved, including investors and rating agencies, become complacent about credit standards. But, this does not change the fact that the process offered a high degree of transparency.

Also, balance sheet lenders such as HSBC's Household subsidiary participated heavily in US sub-prime lending incurring heavy losses. And, of course, there were earlier periods of overzealous lending in the US mortgage market, for example when savings and loan institutions (balance sheet

Figure 7 US house prices 1987-2006



Source: S&P Case Shiller Home Price Index

lenders funded mainly from retail deposits), were hit with heavy credit losses from imprudent lending and subsequently required a government bailout.

3. The role of securitisation in the financial crisis

So, if securitisation suffers less from a lack of transparency and asymmetry of information than other financial instruments, why has it come to be seen as playing such an important role in the financial crisis of 2007 - 2008? Three factors played a pivotal role: The growth of leveraged buyers, particularly banks; the repackaging of RMBS into collateralised debt obligations (CDOs); and the impact of mark-to-market accounting.

4. Leveraged investors

As a mechanism for transferring funds from savers to borrowers, the great advantage with securitisation is it allows funds to be transferred without credit and prepayment risk being concentrated on the balance sheets of leveraged financial intermediaries like banks.

So securitisation should have an important role to play in de-risking the financial system going forward, but only to the extent that the buyers are cash investors such as pension funds. If the buyers are themselves leveraged, securitisation will not facilitate disintermediation.

The RMBS investor base, particularly for UK RMBS, had become increasingly dominated by leveraged investors before the financial crisis, with some 75% of UK issuance being bought by leveraged investors, and around 50% by banks alone².

The intellectual case for banks buying RMBS is that the trading of these securities between lenders allows each lender to diversify its credit risk exposure so, for example, a mortgage bank in Germany could diversify away from a concentrated exposure to the German mortgage market with exposures to other markets with a low correlation of risk because, for example, they are on different economic cycles.

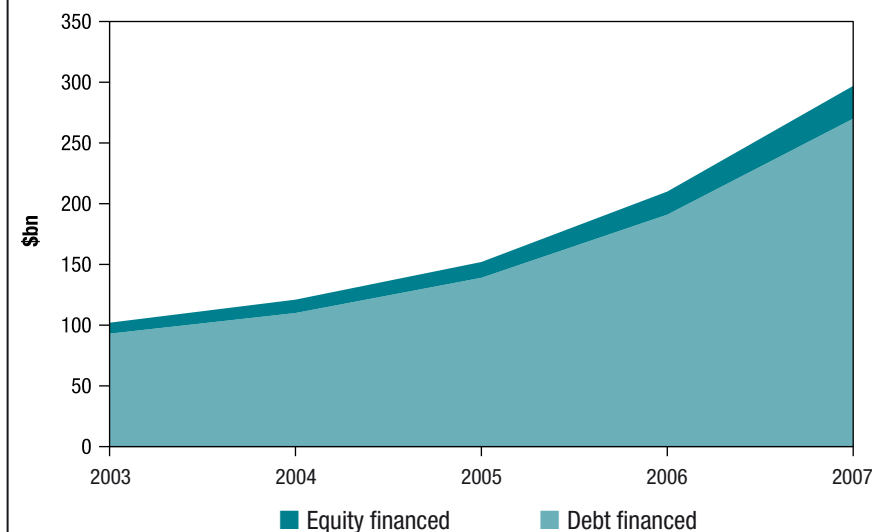
In practice, however, banks were often buying securities with higher yields to enhance profits. In the benign conditions of 2000 - 2006, AAA-rated sub-prime RMBS not only appeared to many to be low risk but, as a result, were easily sellable in secondary markets (i.e. highly liquid), making them seem appropriate as treasury assets (i.e. part of the bank's liquidity buffer). In short, banks investing in RMBS had, like other market participants, become inured of the risks involved.

Banks also set up Structured Investment Vehicles (SIVs) to undertake leveraged investments in Asset Backed Securities (ABS) markets outside of the regulatory net. SIV's combination of low levels of capital, maturity mismatch and

² CML estimates.

Figure 8

Total assets of SIVs



Source: S&P

exposure to mark-to-market volatility in their assets made these vehicles unstable.

Regulators should have been concerned with the systemic implications of SIVs given the collective size of their balance sheets (as shown in Figure 8), but the full implications of this model were not apparent until the financial crisis laid bare its weaknesses.

So, whilst leveraged investment in ABS is not necessarily bad, it does prevent securitisation from fulfilling its primary economic function of disintermediation. It also increases the risk that a credit crisis in one lending market in one region of the world can undermine confidence in those banks dotted around the globe that may have acquired an exposure to that market, creating the risk of systemic fear unless there has been full disclosure on which banks own what.

5. Collateralised debt obligations (CDOs)

The most catastrophic investor losses in the US sub-prime market have stemmed not from investments in RMBS themselves but from mortgage CDOs. These were created by investment banks that bought mezzanine RMBS tranches (e.g. BBB-rated), pooled them and issued bonds backed by them (this is why these are known as re-securitisations).

The economic rationale for these bonds was uncertain, since investors clearly could have bought a selection of BBB bonds themselves to diversify their exposure rather than relying on

an investment bank which would require some form of remuneration.

The aspect of mortgage CDOs that seems to have given them value in excess of their constituent RMBS was the willingness of the credit rating agencies to accept that a pooling of BBB-rated bonds could be restructured into a bond with a top rated tranche of AAA, and the willingness of investors to believe that the AAA label on this tranche implied low risk, even though it was based on a pool of BBB-rated RMBS.

The Council of Mortgage Lenders (CML) supports the measures we have seen from the European Commission to increase the capital requirement for banks holding re-securitisations, and we believe that the poor performance of mezzanine mortgage CDOs has unreasonably tarnished the reputation of securitisation in the minds of some commentators and policymakers.

6. Mark-to-market

The trend in accounting globally in recent years has been towards mark-to-market accounting of financial assets. This is where a firm holding a financial asset must value it on its balance sheet at its then market value and reflect changes in its market value through its profit and loss account. This can be contrasted with the traditional approach in banking of valuing assets such as loans at book value less an impairment charge or provision.

Today, banks can still hold loans at book value less an impairment charge, but accounting

standards have made it increasingly difficult for them to justify valuing debt securities such as RMBS at book value. The shift to mark-to-market accounting is much more than a technical issue and arguably led to a greater destruction of capital in the banking system in 2007 - 2008 than the sub-prime credit shock that sparked investor fears in the first place.

Because it was difficult to estimate projected RMBS losses, buyer interest dried up, sending market values plummeting. This in turn created forced sellers amongst some investors that depended on leverage, such as SIVs and hedge funds, as they could no longer refinance their debt because their assets had fallen so much in value, driving prices down further still. Some banks also had to start selling as they could not afford to take the risk of a further erosion of their capital through more mark-to-market RMBS losses.

In short, mark-to-market losses drove a vicious circle that magnified the impact of the initial credit deterioration, infecting RMBS around the globe regardless of the quality of the underlying credit. The mark-to-market losses were such that they, in turn, began to spark fears that they could deplete the capital of some banks, spreading the contagion to bank debt markets and ultimately creating a systemic panic that only governments could arrest.

Since securitisation is a process of parcelling up a loan or group of loans into smaller pieces, if the intention is to hold the security to maturity, the economic substance of the exposure will be the same whether it is held as a loan or as a security. So requiring banks to mark-to-market their RMBS portfolios unnecessarily created enormous additional volatility in the financial system.

7. Bond performance

Given the events in the US sub-prime securitisation market since 2007, it is important to bear in mind the extremely positive track record of performance of UK RMBS since the first deals appeared in the mid 1980s. No AAA rated UK RMBS has failed to repay in full to date. No bond issued from a master trust has failed to repay in full to date. This supports the view that the structure of securitisation is not at fault but rather that, if the quality of lending is sufficiently poor, it is inevitable that investors will lose out.

8. Policy response

There have been quite different responses to the seizure of securitisation markets in Europe and

the US. In the US, the government has come to the aid of securitisation markets with the Term Asset-backed Securitises Loan Facility (TALF) and the purchase of agency RMBS by the Fed and Treasury. In Europe, the approach has been the opposite, with the European Commission looking at ways to stiffen regulation of securitisation.

The European response, for example in measures like the Capital Requirements Directive (CRD) amendment creating a 5% retention requirement, reflects a perception that securitisation played a major role in bringing about the crisis. It has been easier for European regulators to pin the blame on the sellers and the system (securitisation) that enabled them to pass risk to buyers around the globe than to question why European depository institutions bought higher risk securities using leverage.

The contrast in approach between the covered bond market, with the European Central Bank (ECB) buying €60bn of bonds, and European ABS, where the ECB is tightening requirements for ABS as repo collateral, is stark.

In the UK, superficially the government has been more positive in its attitude to securitisation with the ABS guarantee scheme announced in January 2009. This followed on from the Chancellor's decision, announced in the 2008 budget, to commission Sir James Crosby to report on possible solutions to the hiatus in mortgage finance. However, in reality, the government's policy decisions have not aided confidence. Against the advice contained in James Crosby's report, the ABS guarantee scheme was only made available to deposit takers, who already had access to the Credit Guarantee Scheme (CGS) on terms that made the ABS guarantee scheme unattractive.

The failure to provide a guarantee on the master trusts of Northern Rock (Granite) and Bradford & Bingley (Aire Valley) also marked them apart from these lenders' senior unsecured bonds, which were guaranteed. This was despite the fact that RMBS, as collateralised bonds, would have provided the government/tax payer with security.

More significantly, the Government's decision to allow these master trust programmes to enter wind down, putting the bonds into extension, undermined investor confidence. Even though the wind down was a structural feature of these programmes, designed to protect senior bondholders, its deliberate activation did not come across as a carefully considered policy action but rather was taken by investors as a vote of no confidence in master trust and RMBS.

There has also been a damaging difference of opinion within the tripartite authorities. The

Treasury has taken a relatively positive public line, most recently in the pre-budget report on 9 December 2009 saying 'The government will explore ways of encouraging more sustainable, transparent and standardised UK mortgage backed securities...in discussion with issuers and investors, in order to establish a broader investor base and lay the foundations for stronger markets in the future.' But the Bank of England (BoE) has adopted a negative attitude to securitisation, particularly to the master trust structure, which it sees as overly complex.

9. The outlook for the UK RMBS market

Since the larger UK mortgage lenders first set up RMBS programmes in the late 1990s, the market can be divided into two distinct segments; the specialist lenders relying on stand alone RMBS transactions with a pass-through structure (where investors receive their principal back as and when the mortgages repay) for their funding needs and the large banks running master trust programmes as one element of a diversified funding strategy.

Any examination of the future prospects for the market must take account of this distinction because the drivers of these two segments are quite different.

10. Large bank programmes

The large banks will issue into the RMBS market if it compares favourably with other funding sources in terms of characteristics such as price, duration and reliability. They will also value the diversity of funding it provides and the ability to access a different investor base.

A good test case for the UK master trust structure was the issue from Permanent master trust in September 2009. The AAA only deal was priced at 185bp over Libor, but crucially it featured a put option to investors at 5 years. This made it more like a covered bond than a traditional RMBS from an investor standpoint, and it was supported by JP Morgan, which bought a tranche and provided repo finance against another.

Therefore, the deal could not be said to represent a fully fledged re-opening of the UK RMBS market, but it was an important step on the road. Interestingly, the transaction did show a welcome shift away from leveraged investors with a significant switch away from bank purchasers to funds (see Figure 9).

Some investors have expressed concerns about the master trust structure, and it is known that the BoE

has been critical. Yet the Lloyds and Nationwide deals show that investors are voting with their feet and supporting master trust deals.

Again, RMBS seem to have come in for undue criticism. Investor concern with master trust stems from its revolving nature, meaning the quality of the loans can change over time. But, again, consider the comparison with a senior unsecured bond – it is certain that the nature of the business of the issuer will evolve over time and the bondholder has no real control over the risk associated with that evolution.

By comparison, the potential for drift in the quality of loans going into master trust structures seems an acceptable risk given the nature of the issuers and the safety features, for example with a random cross section of qualifying prime mortgages going into the pool with the rest remaining on balance sheet.

The other main criticism of master trust, voiced in particular by the BoE, has been its complexity. However, this complexity of structure has been designed to support a greater simplicity in the bonds issued, allowing bonds to carry set redemption dates, while protecting senior bondholders in the event that the structure has to be wound down. There is no doubt that a wider range of investors can be attracted to RMBS by offering such soft bullet bonds. Therefore, master trust fulfils an important role that should not be lost.

Master trusts are also an efficient way to obtain RMBS funding backed by mortgages with flexible features such as over/under payment and payment holidays (as required increasingly in the prime mortgage market). Master trusts also provide an efficient mechanism for ensuring that the risk of set-off, flexible redrawing and unenforceable loans are absorbed entirely by the sellers' interest rather than the RMBS investor.

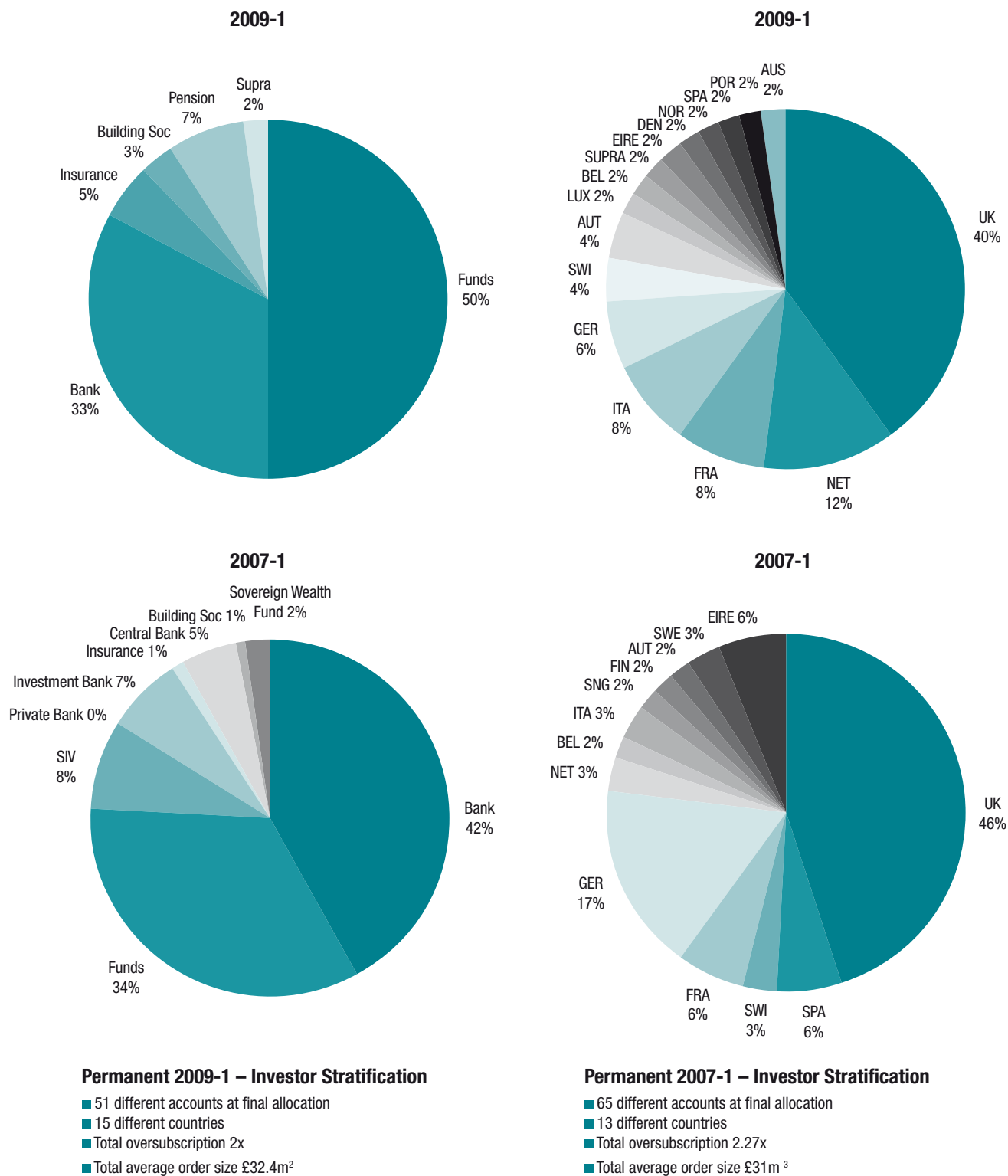
One of the key reasons banks first launched master trust programmes was that under Basel I securitisation released regulatory capital, but under Basel II this capital relief is likely to disappear as the capital required for low risks assets held on balance sheet falls. Unless regulatory capital requirements are maintained at artificially high levels, for example through the extension of Basel I capital floors or by a universal leverage ratio, the capital benefits from securitisation are likely to be greatly diminished.

This is likely to produce a smaller master trust market in future, but one based more on fundamentals rather than an element of capital arbitrage, which could be seen as a positive development. However, the government support provided to senior unsecured bank creditors has also made master trust

Figure 9

Details of Lloyds' recent RMBS deal

PERMANENT 2009-1 VS. PERMANENT 2007-1¹



¹ Note - only the AAA EUR & GBP publicly issued tranches of 2009-1 and 2007-1 have been included in this analysis

² EUR orders converted to GBP at EUR/GBP spot rate 0.9005 as of 13-Sept-09

³ EUR orders converted to GBP at Historical EUR/GBP spot rate 0.6723 as of 21-Feb-07

Source: Lloyds Banking Group

RMBS relatively less attractive to investors, which risks distorting the market.

11. Non-deposit taker RMBS

There are a number of reasons why you might expect the non-deposit taker RMBS market to recover more slowly. Most of these lenders are dependent entirely on the securitisation market for their funding, with limited balance sheets of their own. Thus, these lenders do not have the ability to encourage the market in the way that Lloyds has by issuing a new deal with a put option.

Secondly, they tend to operate in niche mortgage markets where credit risk is higher, and investor appetite for such risk is likely to be muted for some time to come. Thirdly, because of their lack of a balance sheet, they are dependent on warehouse funding lines from banks and re-opening such lines will not be a priority for many bank providers.

However, investor feedback has been supportive of the stand alone RMBS structures used by non-deposit takers. And the original business case of most of these specialist lenders, that they could cater for under-served borrower segments, is perhaps stronger today than it has ever been, given that the tightening of lending criteria has left a large number of borrowers and potential borrowers unable to access mortgage credit. And the recession will have also increased the number of borrowers with blemished credit records.

This combination of investor confidence in the structure and high potential mortgage margins available in niches markets currently being under-served should provide a path back for the RMBS market for non-deposit takers.

Warehouse providers should also be attracted back by the potential to take a substantial slice of the margin. The constraints facing the balance sheet lenders, with £300bn to be repaid in SLS and CGS funds, suggests that these lenders are unlikely to make a rapid return to higher risk segments, so the under supply of credit and high margins that currently characterise these markets looks set to remain a feature for a number of years to come.

However, there is considerable uncertainty about the regulatory environment that non-deposit takers will face, and a sense that the FSA may put up barriers based on the attitude expressed in the Mortgage Market Review (MMR) which associates non-deposit takers with the problems that afflicted the US sub-prime market. It would be unfortunate if non-deposit takers were unable to pursue an otherwise sound business case

by an overly cautious FSA, influenced more by events in the US than by the track record of lenders in the UK.

12. A preferred approach to restoring a healthy RMBS market

We believe that securitisation should play a vital role in aiding the government's withdrawal from funding support and de-risking the financial system. In looking to build a more stable securitisation market, we believe that policymakers should focus on the weaknesses outlined above as follows:

■ Building a domestic cash investor base.

Measures should be put in place to encourage cash investors, particularly domestic institutions, to become regular buyers of UK RMBS. Regulators should monitor the balance between leveraged and cash investors with an understanding that a preponderance of leveraged investors is likely to signify excess liquidity.

■ Mark-to-market accounting.

We believe that the correct accounting treatment for RMBS and other bonds backed by loans should be determined by whether the bonds are being held to maturity or being traded. Where they are being traded, mark-to-market accounting is appropriate but where they are 'buy and hold' investments they should be held at book value less an impairment charge as would a loan.

■ CDOs.

We support proposals contained in Capital Requirements Directive (CRD) III to require banks to hold more capital against investments in re-securitisations if proper due diligence is not undertaken.

But the largest single obstacle to the UK RMBS market's recovery is the extent to which other funding channels (retail deposits and senior unsecured bonds) have been seen to receive preferential government support. Redressing this imbalance should be a priority.

We support moves to create a more transparent and standardised RMBS market but, as we have consistently pointed out, these are not the core issues holding the market back. RMBS could benefit from more transparency but they already compare favourably to other bonds in this respect, and greater standardisation will aid investors but, again, the lack of standardisation was not at the heart of the market dislocation seen since 2007.

The crisis was above all driven by the excessive use of leverage by investors, which allowed the RMBS

market to become the receptacle for excess global liquidity. An RMBS market with a strong presence of UK cash (unleveraged) investors should form part of a more sustainable funding market.

Conclusion

Reasonably, the UK authorities provided the fullest support for the funding markets that matter most; retail deposits and senior unsecured bonds from the largest deposit takers. By comparison, however, there has been an absence of effective support for the RMBS and covered bond markets. This contrasts with the US and continental Europe which have respectively supported the RMBS and covered bond markets because of the vital role these markets play in the financial system in these jurisdictions.

The unintended adverse consequences of the UK policy response has been to create an unlevel playing field in funding, with retail deposits and senior unsecured bonds being advantaged relative to RMBS and covered bonds.

With strong support for these markets in other countries, the UK risks losing out in competition for global investors and indeed even amongst our own institutional investors, who might conclude that it is safer to fund mortgages abroad. Retail deposits alone cannot support the size of mortgage market we have in the UK, and a dedicated funding instrument which provides wholesale investors with a claim on mortgage assets provides an important additional market discipline.

The government should level the playing field by providing more tangible support for UK RMBS and covered bonds. This could take the form of temporary purchase programmes of the sort conducted by the Fed and ECB, and a change in the regulatory stance to remove barriers to the use of these funding tools. In the absence of such support, the UK may well find it difficult to re-establish RMBS and covered bond markets on a scale sufficient to plug the funding gap, leaving us with a reliance on government funding and the risk of an under supply of credit for a prolonged period.



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The Planning System and Land Provision for Social Housing in Turkey

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1. Introduction

Provision of housing in a country depends on meeting the needs of the whole community including those whose needs are not met by the housing market and includes a good balance of housing types and tenures. Mostly, governments intervene to produce social housing because housing is seen by most governments as in part a social good at least to the extent that society's welfare is improved if minimum standards are achieved by all households (Le Grand et al., 1992). This is particularly difficult if the distribution of income is very unequal and housing is relatively expensive. It therefore points to housing specific assistance being made available to those unable to achieve these standards for themselves (Whitehead, 2007, p.30).

Social housing is provided at sub-market prices, and state interventions are necessary to address the problem of inadequate supplies of affordable housing. Certainly, one of the most important interventions is the provision of land for social housing, because landowners usually prefer more profitable land uses than social housing. High land prices make the provision of social housing costly. Substandard quality locations, where social housing is the most profitable land use, are limited (Needham and De Kam, 2004; De Kam et al., 2008). These sites need to conform to standards for safe and sound housing, without risk of land slides, flooding or other hazards. Land provision practices for social housing are very important. Examination of these practices is closely related to the interaction of planning and land policies (Chiu, 2007).

The aim of this paper is to analyse the impact of planning and land policies and practices on land provision for affordable housing in Turkey. That is, its objective is to examine whether, and how effective, planning tools and land policies can

play a role in providing affordable housing and using Turkey as an example to do this.

A discussion of Turkish planning and land policies and practices of land provision for affordable housing is relevant for the following reasons. Firstly, Turkey has high rates of urbanisation. The degree of urbanisation has risen from 18.5 % in 1950 to 65.6 % in 2000. Since the end of World War II, due to this fast urbanisation, the need for supply of land to meet the growing demand for urban housing has increased enormously. This demand was the beginning of the formation of squatter settlements in Turkey (Keles, 2002). Secondly, Turkey has a legal-illegal (dual) market structure. This dual structure is especially dominant in housing markets (Yönder, 1998; Baharoglu and Leitmann, 1998). The number of squatter houses increased from 50,000 in 1955 to 2.5 million in 2002. As much as 29% of the urban population, which is a total of 12.5 million people, lives in squatter dwellings (Keles, 2002). Thirdly, Turkey has an unequal income distribution. According to TurkStat data (2004), the minimum (first 20%) income group earns 6% of the total income, while the maximum (fifth 20%) income group earns 46.2% of the total income. Fourthly, urban and rural areas are extremely vulnerable to natural disasters. 92% of Turkey's area is located in an active earthquake zone, and 95% of the total population is exposed to earthquake risk (Jica Report, 2004). All these problems demonstrate the importance of land provision and state intervention for social housing to ensure enough quantity and quality of housing at a reasonable price. There is no clear and systematic social housing policy in Turkey. However, after the 1980s there were some attempts by the state to draw up an outline framework for a social housing policy. Since 2003, there have been important changes in the approach of the state to social housing. Another

important aim of this paper is to discuss the effects of this policy and changes in practice on land provision for social residences. Discussion about land provision for social housing in Turkey provides a contribution to international literature.

This paper is organised as follows: the second section cites literature related to land provision for affordable housing in the framework of international literature. The third section includes an analysis of approaches to land provision for affordable housing in Turkey, and changes in the institutional context of TOKI and municipalities (central and local governments), and the effects on social housing. The fourth section outlines the interaction between the planning system and land supply in Turkey. The fifth section discusses whether planning and land development tools can be used as a remedy for social housing provision in Turkey. The sixth section gives a general evaluation.

2. Literature Background: Land provision for affordable housing

Social, or affordable, housing is intended for people who cannot afford to buy or rent housing under market conditions (Needham and De Kam, 2000). That is, social housing involves house production below general market prices. There are a number of ways in which general prices can be reduced and so address overall affordability: by modifying demand (e.g. by reducing net incomes or increasing the relative price of housing); by reducing the real resource costs of producing housing (e.g. technological change or by making supply more elastic); or by liberalising the regulatory system to ensure more housing land is made available (Whitehead, 2007; p. 31). Choosing the second or third method is directly related to land provision for social residence.

There are important limitations that affect the land provision for social housing. Social housing providers are in a weak position to provide land under market conditions (Needham and De Kam, 2004). Returns are relatively low in social housing production compared to commercial housing production. Social housing goes with low rental incomes, and with low rental income, only low land prices can be covered (DeKam et al., 2008). In addition, it has been accepted that social housing negatively affects the nearby residence prices (Needham and De Kam, 2000).

These limitations provoked state intervention to provide land for social housing. In a study by De Kam et al. (2008) types of interventions have been classified and specified. According to this study, state intervention in land provision for social housing can be separated into five parts. First is state financing and provision of social housing. In this intervention, there are direct state subsidies on land and the construction of social housing, or subsidies to tenants who can receive housing benefits.

The second are interventions in property rights related to serviced land. This type of intervention takes place in five different ways. In the first, the state directly buys the land and provides freehold land for social housing. In the second, the state provides leasehold land for social housing. Third, the state directly undertakes the social housing development. Fourthly, land provision for social housing is provided via expropriation. Fifth, the state enforces the private entrepreneurs to produce social housing as part of regular housing production programmes by instruments such as inclusionary zoning (see also Whitehead, 2007; Mukhija et al, 2010).

Third are interventions in social housing institutions. These cover the housing costs (residence and land or construction) from their own budget, which may be nourished through cross-subsidisation from the incomes of commercial housing sales. Social housing providers may follow market strategies like speculative land provision, or unserviced land purchasing. Or social residence providers may develop non-marketing strategies.

The fourth intervention method is the participation of developers in social housing projects through market strategies, which means that land provision for social housing has direct economic advantage for them, for example, a building company that may achieve higher production rates by providing social housing in a time when the housing market is stagnating.

Fifth is the participation of developers in some social housing projects with 'non-market strategies' (De Kam et al, 2008) with the aim of either

improving relationships with local authorities, or motivated by corporate social responsibility and community engagement.

In literature, it has been stated that the provision of land for social housing is a process which is often not fully co-ordinated with price. This means that land provision for social housing is not only a financial problem but also an institutional problem (Needham and De Kam, 2004). That is, the process can be considered in the concept of the 'coordination-mix' as elaborated in new institutional economy (Buitelaar 2007). Providing land for social housing can be co-ordinated by the market, by hierarchy or by networks. In practice these three mechanisms are rather being used in a specific mix than excluding each other (De Kam et al. 2008; Garside, 2001; Needham and De Kam, 2000). It can be considered that the structure of this mixture differs according to countries (De Kam et al. 2008).

It can be said that as a general tendency, bureaucratic allocation of public and/or social housing has become less common, and patterns of access to housing have become increasingly market-driven. As non-market forms of housing provision have been increasingly replaced with market forms of provision, so the scope for the state's involvement in the production and distribution of low cost housing is reduced (Paris, 2007).

The market forms of provision can be (De Kam 1998):

- Taxation on property, building land and development gains
- Betterment levies
- Increased specification in zoning, regarding quality, mixing in tenure and price, and other factors influencing urban and social quality as well as development gains
- Legislation to force developers to build and/or reach agreements between each other and with government agencies

Additionally, Land Readjustment [LR] can be used as a tool to provide social housing. LR has been defined as land consolidation or land pooling by a government agency for the unified planning, servicing, and subdivision, with the sale of some of the new plots for cost recovery and the redistribution of other plots to the landowners (Doebele, 1982; Larsson, 1993; Archer, 1999). There are some approaches to include costs related to social housing into LR projects (Turk, 2008). The first approach is to sell cost-equivalent land at a reasonably low price to the agencies producing low-cost housing and to finance the amount returned to the landowners by cross-subsidy. The second one is, before LR,

the inclusion of agencies producing houses for low-cost housing into the project as a landowner by purchasing land from the project area. The third approach is the allocation of financial surplus to be obtained from increasing land prices for low-cost housing production during LR. The fourth approach is to use some landowners' plots to construct multi-unit housing for rent or sale to low-income families. The fifth approach is to increase the land deduction rate at a certain level taken from landowners to finance public services. All these approaches to low cost housing can be chosen depending on the housing policies of the countries. For example, while the first approach is used in South Korea (Archer, 1999, Doebele 1982), both the fourth and fifth approaches are used in Spain (Munoz Gielen and Korthals Altes, 2007).

The problem in developing countries is that the low purchase powers of the low paid is much more an impediment to the provision of land through the formal private sector than in developed economies (Keivani and Werna, 2001). Moreover, "...low income housing provision in developing countries involves an intricate and complex network of relationships between various agents and the state" (Keivani and Werna, 2001, p. 111). It is therefore relevant to "...take into consideration the entire structures of provision and the interactions of the relevant interest groups and agents involved in the various submarkets and forms of housing provision." (Keivani and Werna, 2001, p. 111) Strategies that are aiming to develop formal ways of provision of land for social housing may overlook the informal ways in which housing land is actually provided (Keivani et al, 2008). This paper analyses the ways that a formal structure has been developed in Turkey; that is, a context in which illegal land development is a dominant form of provision of land for low and middle income housing.

3. Land provision for affordable housing in Turkey: planning system and land supply

Three problems related to land supply for affordable housing in Turkey

3.1.1. Quantity

According to the calculations of the State Planning Organisation (SPO), the amount of housing needed between 1990 and 2005 was 7,868,400 units in urban areas. In the same period the number of dwellings having construction permits was 6,221,915 and the number of dwellings having occupancy permits was

3,632,123. This data shows that the supply of housing stock produced over the last 15 years has not met demand. 203,685 hectares of land are needed for housing in Turkey between 2000-2015. To reach this aim, 13,579 hectares of serviced urban land needs to be produced yearly (TurkStat; 2001).

3.1.2. Quality

There is a significant difference between the number of residences with an occupancy permit and the number of residences that have a construction permit. The construction permits given for illegal buildings under amnesty laws enacted between 1983 and 1988 are the most important factor for this difference. These buildings have not met the quality standard sufficiently to be given an occupancy permit with the progress of time (Housing Special Expertise Report, 2002). Furthermore, this situation provides information with respect to the quality of the present housing stock.

Another factor affecting the quality of housing is the age of the present housing stock, especially in big cities (30% of current buildings are older than 30 years and 11% of those are more than 50 years old), because this causes a serious danger in terms of earthquakes. The 1999 Marmara earthquake redefined the problems of existing older housing by revealing much of it to be in a life threatening condition. A cumulative shortage of housing stock with licenses and minimum standards and quality increasingly continues (GYODER, 2006).

3.1.3. Price

The high level of costs of serviced urban plots in housing production is an important problem for the housing supply in Turkey. Prices of serviced urban plots with legal building status are high; the share of serviced urban plot prices in housing production with the official construction permits reaches 50% in the legal market (Alkan, 1999). This is different from the illegal land market, where much lower prices apply. It appears that the illegal land supply is much more elastic to demand than the supply of legal building land, which may be attributed to the hierarchical planning system in Turkey (Turk and Korthals Altes, 2010). The imbalance of the distribution of income in Turkey also leads to a high diversity of residences. This also causes a wide diversification of prices. The prices of top-end residences in Istanbul are in the 5,000-7,000 €/m² range. In addition to land and construction costs, a sum of contractor profit and profit of landownership is added (Yetkin, 2005). Most of the structures in the housing stock are directed

toward middle and upper income groups. The higher returns from residential property have caused increasing interest from both domestic investors and foreign investors. (Turk and Korthals Altes, 2010).

On the other hand, according to a study related to the price of affordable housing in Istanbul (Bölen et.al., 2006), the share of monthly expenses including rent in the household income reaches to 40% for renters in the sample. The price of housing is 16 times that of annual household incomes. Besides, 61% of households in the sample earn under 1000 YTL(€ 520) (Bölen et.al., 2006).

3.2 Land supply practice for affordable housing

In the Turkish legal system, the private sector has been predominant in housing production whereas land development by different landowners is dominant in the land development process. Mostly the "single plot-single building" approach has been determinative for the development of urban areas in Turkey. Land development by different landowners is basic (Turk, 2004).

Policies related to illegal housing have affected the land supply for affordable housing. Illegal housing has been a significant problem since the 1940s in Turkey. Solutions proposed for this problem have been changed over time. Until the 1960s, three approaches were adopted. The first approach was the demolition of squatter areas and not allowing reconstruction. The second approach was the provision of building land for poor and low-income people to prevent squatter settlements. The third approach was the legalisation of squatter housing built previously. In the 1960s Squatter Law No. 775 was implemented. According to the law, up-grading, clean up and prevention areas were determined. Within these areas, the municipalities have the opportunity of land acquisition as a means of purchasing or expropriation. Again, it was provided that the municipalities get the lands that belong to the state free of charge. These areas were used for production of low-cost housing and the land was sold at low cost. Yet, in some circumstances, part of the land could be sold or rented by municipalities for other, non-social housing, purposes, providing, the revenues were transferred to the squatter housing fund.

Prior to 1980, the effect of co-operatives on the production of social housing was low. While their contribution was 5% of total housing supply until 1970, their share in total housing production had increased to 10-15% in the 1970s. At that time,

there was no centralised system for the financing of social housing. Different public authorities like social security institutions (SSK, Bağ-Kur, OYAK, T. Emlak Bankası) and central government units (Ministry of Public Work) contributed to social housing financing prior to 1980.

Two important changes have had an effect on the land provision for social housing since the 1980s. One of them is the legalisation of squatter houses. In the context of the 1980s structural changes, a general building amnesty was issued in 1983, followed by a number of amendments until 1989. The logic of Amnesty Law No. 2981/3290 was to upgrade existing illegal housing areas and to prevent new informal settlements (Baharoglu and Leitman, 1998). The law brought a special type of plan: the improvement development plan, which included unification of irregular, haphazardly formed parcels and their redesign to create new parcels of maximum 400 m² and to allow construction of four-story apartment buildings (Dundar, 2001). In this way a transformation from squatter to apartment has emerged. This renewal has been realised directly by landowners (who have a title deed allocation certificate) or by contractors (builder-and-seller) at the single building scale.

The second is the establishment of the Mass Housing Administration (TOKİ) in the framework of Mass Housing Law and the Mass Housing Fund outside the general budget. TOKİ was established apart from the General Administration in 1984. An autonomous Mass Housing Fund was established by Mass Housing Law No. 2985 which came into effect at this date. The Mass Housing Fund apart from the general budget had continuous and adequate resources for TOKİ housing developments. With Mass Housing Law No. 2985, housing credits were provided to both housing user and housing producer (housing co-operatives, co-operative associations, private partnerships and developers). So, the roles of housing co-operatives in housing supply have become stronger. While 140 housing co-operatives were established yearly prior to the Law, 2700 housing cooperatives have been established yearly since. Between 1985 and 1990 housing co-operatives significantly increased their share of housing production. In this period, housing co-operatives had met 30% of total housing production. While their share in covering the costs of credits was 77%. After 1988 this share decreased to 7% because of restrictions in the Mass Housing Fund possibilities. This caused a decrease in the number of housing co-operatives and increased the completion times on construction to seven to eight years (www.toki.gov.tr).

In 1993, there had been a decrease in the Mass Housing Fund after it was included in the general budget. Consequently, TOKI's support for housing construction gradually decreased. The Mass Housing Fund was revoked totally with the Law No. 4684, dated 20.06.2001. With the revoking of the fund, TOKI became dependent on the allocations transferred from the budget (Bayraktar, 2009). The share of housing co-operatives in housing production decreased to 14.5 % in 2001, and the share of the private sector increased to 76.5%.

3.3 Changes in the institutional context of TOKI and municipalities (central and local governments) and the effects on social housing

TOKI's authority has widened and so its resources have increased by regulation after 2003. The first of these regulations was the amendment No. 4966, and dated August 6, 2003. With this amendment, TOKI became authorised to have projects and developments for profit in order to provide resources. "The Revenue Sharing Scheme in Return for Land Sale" model has been used within this framework. The aim of this scheme is to provide resources for TOKI. The second important amendment is that all duties of the Land Office were passed to TOKI by the Law No. 5273 on December 15, 2004. With this amendment, TOKI became authorised to operate in land banking. Moreover, TOKI acquired the right to compulsory purchase for land belonging to private owners for housing, education, industry, health and tourism investments and public institutions. The third amendment was made by the Law No. 5162 on May 5, 2004. TOKI became authorised to make local physical plans for the areas where the property belonged to TOKI or was designated as a mass housing area or a squatter prevention area. In other words, a special planning authority was given to TOKI. The fourth amendment is that TOKI became authorised to without charge, to take over the lands of public domain upon the proposal of the relevant Minister and the Ministry of Finance and the approval of the Prime Minister. This authority means that TOKI can use primary public domain lands in order to develop projects. In other words, the necessity for transactions such as compulsory purchase required for land acquisition are removed. The Fifth Amendment is that TOKI has the authority to realise urban renewal projects in both illegal housing areas and areas where existing urban renewal laws (Laws No. 5366 and 5104) are applied. The sixth amendment is that TOKI has a special legal position in relation to financial control.

With all these responsibilities, TOKI has both regulatory and investor roles. It has become an important player in the housing market by providing around 5-10% of the total housing need. TOKI has directly intensified the construction of social housing. While the share of credits in total expenditures was 53% in 2002, 31% in 2003, this share decreased to 11.5% in 2004 (Geray, 2006). Between 2003 and 2009 TOKI has produced 359,677 housing units. 306,733 (85%) of these dwellings are social housing, the others are market housing. Especially, in Istanbul TOKI develops mass housing projects for upper-middle income groups in order to raise financing for their other social housing projects.

Since 1950 legislation enabled the municipalities to produce legal housing (Law No. 5656 that was supplementary to Law No. 1580), this power had rarely been used by the municipalities, except in some large cities (Keleş, 1990). At the beginning of the 1990s, metropolitan municipalities particularly, started to carry out housing developments by starting their own municipal companies. Municipal companies are private legal persons working under Turkish Trade Law. Because of their structures, they work in accordance with the market rules and they remain out of the public audit field. These companies can be controlled by the Commerce and Trade Ministry. Execution of these duties by municipalities through these companies is a kind of internal subcontract. Their decision-making bodies consist of members of the municipal council and the decision making process is controlled by the executive of the municipal administration. However, the company is legally a private entity and must compete with other companies to get these subcontracts. Corporate foundations are present in all metropolitan municipalities. 70% of the central province municipalities have got at least one company, or they are a partner in a company. Municipalities are also able to start a corporation for the purpose of supplying housing (www.yerelnet.com). KIPTAŞ belonging to the Istanbul Metropolitan Municipality and is an example of this. The project in the first case area was developed together with the Istanbul Metropolitan Municipality and KIPTAŞ, and this was one of the first examples developed in such a way. When the project on the first case area started, there were no specific legal arrangements related to property development. These arrangements came later. The first legal arrangement was achieved with the Municipality Law dated July 3, 2005, numbered 5393 and Metropolitan Law dated July 10, 2004, No. 5216. With the Municipality Law No. 5393, municipalities acquired the right to start a corporation for development, buying land, compulsory purchasing, building houses on these lands and

developing projects with banks, selling and hiring these properties within its borders. As a result of all these legal regulations, the local administrations are direct investors, and implement housing projects directly through their own companies, enter into projects for profit and establish various partnerships (Turk and Korthals Altes, 2010).

4. Planning System

A hierarchical statutory planning system is responsible for land use planning and development control in Turkey. Plans are separated into two groups in terms of the area they enclose and the usage purpose in the Reconstruction Law which came into effect in 1985, i.e., regional plans and local physical plans. Regional plans define the socio-economic development trends, development potentials, and sectoral targets of the settlements. Although they have been defined by the law, "regional plans" have not been produced in Turkey to date (Mengi and Keleş, 2003; Turk and Turk, 2006). There have been attempts to correct this deficiency with top-level land-use plans. Top-level land-use plans are made for the area that encloses one or more provinces which show administrative, spatial and functional integrity. With these plans, it is aimed to secure the protection-use balance between the urban-agrarian structure and the developmental and natural and cultural values and the determining of the land use decisions. Local physical plans, if extant, have to be in accordance with the provisions of the top-level land-use plan.

Apart from the top-level plan, there is also the metropolitan area master plan prepared for metropolitan areas. This plan includes basic land-use decisions in metropolitan areas and investment decisions at metropolitan scale. Local physical plans in the metropolitan area, if existing, have to be in accordance with the metropolitan area master plan decisions. Both the top-level land-use plan and the metropolitan master plan provide information with respect to public investments. Top-level land use plan and metropolitan area master plan decisions are legally binding on local level plans, and all parts are obliged to obey these decisions. The top-level land-use plan decisions, or metropolitan area master plan decisions, can only be changed under certain conditions and for reasons of "public interest". The change process is long and very hard.

Local physical plans in Turkey are divided into two basic groups. The first is the local land use plan and the second is the detailed local plan. The local land use plans must be

made in accordance with the top plan decisions (regional plan, top-level land-use plan or metropolitan master zoning plan, if extant) and this plan shows the general usage forms of the land, usage zones, population density of these zones, development direction and size of the settlement areas and their principles and resolutions relating to transportation. A detailed local physical plan is a plan prepared in accordance with the local land use plan and it shows the various buildings structures, their density and structural arrangement (front, back and side yard distances), the height of the buildings, roads (pedestrian and vehicle section). Both local land use plan decisions, and detailed local plan decisions, directly affect the land development process, because the provision of urban serviced land units, construction permits and inspection all have to be in line with the planning requirements.

Plan amendment, or plan updating, are needed if a new development does not suit the present local land use plans. While the plan amendment means changing planning decisions on a parcel scale, plan update involves more extensive changes over a big part of the city or overall plan. In Turkey plan amendments are based on the same basic principles. These principles are that the changes must be based on reasonable grounds, must consider the public interest, and not jeopardise the integrity of the plan and its main decisions (Altın and Turk, 2005). A plan amendment must be made in accordance with the form defined in the Reconstruction Law. Plan amendments and updates must be submitted for approval by the council. The decision making process for plan amendments and updates are the same as for new plan development.

In 1985 with the acceptance of the Reconstruction Law, the approval authority of the local physical plan was assigned to local administrations (municipalities). As a result of this, municipalities have started to change their plans since the beginning of the 1990s. The highest number of plan amendments is in Istanbul. During the 1980s, 400 changes were made, during the 1990s there were 450 changes, and during the 2000s there were 850 changes while in the last 3.5 years there have been 3800 changes (www.tbmm.gov.tr). The basic problem with a local detailed plan amendment is that most of these changes have no reasonable or suitable grounds according to the law. As a result, most of these plan amendments can be cancelled by the administrative courts (Turk and Korthals Altes, 2010). It is clear that the value of the real properties increases with the new plan decisions or plan modifications on the urban parcel but such increased values cannot be utilised for the public interest.

5. Can planning and land development tools be used tools as a remedy?

When the planning system is examined, it can be seen that urban-planning and land-development tools have not directly affected the land provision for social housing in Turkey, especially in the sense of a good balance of housing types and tenures. On this point, some questions can be meaningful. The first is whether planning and land development tools can be improved in land supply for social housing apart from central government tools. The second is how these tools can be integrated to a general system that is shaped with some institutional changes.

When the planning system in Turkey is examined, 'land readjustment (LR)' or 'taxation on property, building land and development gains' can be considered to be applicable. Turkey has an important past and experience related to land readjustment (Turk, 2005; Turk, 2007). In Turkey, the LR method is applied, in conjunction with the local physical plans, to manage the readjustment and development of built or green field areas, to produce serviced urban land in a form and of a size complying with the local physical plans, and to provide land for on-site and off-site service areas. Only one contribution ratio is determined within the project area. This contribution ratio is found by dividing the amount of land utilised for public services areas into the total amount of cadastral parcels in the LR project area. This ratio is applied to each plot. The contribution percentage from each plot must be used in order to provide lands allocated for public services like roads, squares, parks, car parks, playgrounds, green areas, elementary and secondary education areas, religious facilities, and police stations within the project area. The maximum contribution percentage in LR projects is 40% for each plot. If the contribution percentage is greater than 40% within the project area, the municipality must use expropriation in order to reduce it to 40%. A percentage for social housing can be determined and added to the contribution percentage. However, before such an arrangement is made, the provision of the efficiency of LR in an integrated way is needed. The effective use of LR in providing serviced land depends on the elimination of formal, administrative and technical problems in the applicability of the method (Akdeniz, 2001; Turk, 2005; Turk, 2007).

Secondly, changes in planning status can be used for social housing or service and infrastructure areas. Development rights in relation to serviced urban land can be changed with local detailed plan amendments under certain

circumstances in Turkey. In most of the cases, the aims of these changes have been the change the designation for development purposes such as from service area functions (parks, car parks and playgrounds, etc.) to residence or trade functions or an increase in the floor area coefficient (Altın and Turk, 2005). That is, important gains occur as a result of planning changes and these gains have not been taxed. For proper urbanisation, these gains are required to be taxed and transferred to the public. The tax receipt can be used for the land provision of social housing.

The use of these two options depends on two important conditions. Firstly, the adoption of the value-based approach, instead of the area-based approach, is needed. Secondly, a range of municipal programmes and policies for low-income housing be improved. The provision of the first condition would need an extensive revision of the planning system. The second condition is much easier to achieve. The local government legal framework post 2004 requires that municipalities have to prepare their own strategic plans. Within the scope of the strategic plan, municipalities can prepare a programme for their social housing needs in their own territory. In this sense, institutional capacities of municipalities should be strengthened.

6. Conclusions: Some lessons from Turkish Case

Turkey has a dual legal-illegal structure in relation to land development and housing construction. It can be considered that squatter settlements are a result of the absence of government carrying out its own duty to meet the housing needs of the poor. 29% of the urban population, a total of 12.5 million people, live in 2.5 million squatter houses in Turkey. This means that there are serious shortcomings in social and technical infrastructure arising from illegal housing. Certainly, the structural quality of the housing stock is an important issue in the big cities, and causes serious dangers as the area is likely to be hit by an earthquake sooner or later. Given such a picture, the importance of land provision for social housing in Turkey is indisputable.

In Turkey, the central government has been active in the construction of social housing since the 1980s, and currently operates both as regulator and as a provider of social housing. While the basic strategy of TOKI as a central unit had been the financial support to social housing units between 1984 and 2003, this strategy has changed and since 2003 TOKI has tended to be a direct provider of social housing.

At the local level, before 2004, municipalities produced a limited amount of social housing, either via housing co-operatives or land provision in squatter prevention areas. After institutional changes related to local governments in 2004, most of the municipalities have begun to produce market housing instead of social housing. There is still an important deficiency in land supply for social housing. The removal of the problem at central level is not enough. The local level has also a role to play.

In recent years, governments in many countries have explored ways of using statutory land-use planning systems to influence the provision of additional affordable housing, especially, in localities with relatively high house price and rental costs (Paris, 2007). 'Land readjustment' or 'taxation on property, building land and development gains' can be considered for Turkey. However, the achievement of such a situation depends on an extensive revision of the planning system and increase in institutional capacities of municipalities.

Introducing such modifications involves more than enacting a law prescribing possibilities. Also plans or zoning ordinances regulating land use do not necessarily result in investment to develop property, especially in the case of less-renting land uses as social housing. The use of specific policy tools, such as 'land readjustment' or 'taxation on property, building land and development gains' to promote the supply of land for social housing may, on the one hand, work-out positively as it creates opportunities for the supply of well-serviced plots for social housing, on the other hand, this may make legal urban development more expensive as it involves charging development or the obligation to cede land for public or social uses. In this way it puts a price on legal development, and may even enlarge the share of illegal houses. The interaction of legal and illegal markets in the supply of land for housing in the specific context of the use of instruments for land development should be taken into consideration, which involves a concerted approach using measures that promote legal land supply and measures to deter illegal development.

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The Private Rental Market in Flanders: Growing Poorer

↪ By Sien Winters¹

1. Introduction

Belgium is a federal state with three regions. Since 1980, housing policy belongs to the responsibilities of the regions. In terms of population, with 6,078,000 inhabitants and 2,500,000 households, Flanders is the largest of the three Belgian regions. With a GDP of 30,100 euro per capita in prices in 2008 (Estimation of the Study Department of the Flemish government) it is one of the most prosperous regions of Europe.

Buying a home is an ambition of almost everyone in Belgium and Flanders. For this reason, the increasing share of homeownership generally is seen as a success. However, the downside of this evolution is a shrinking private rental market. The consequences have become increasingly apparent in recent years and point to the urgent need for a policy on the private rental market.

In this article, we describe the current situation on the private rental market in Flanders and discuss the policy. Around the world the term 'private rental market' or 'private rental sector' covers many different rental situations. Haffner e.a. (2009) argue that a definition of the private rental sector that is based on the allocation process offers a good basis for comparative housing research. The defining feature of private rental housing in this definition is that market forces play an important role in the allocation of accommodation. Organisations in the private rental sector operate in price-driven markets where resources and access to market are allocated according to ability to pay. In this article we examine this feature of the private rental market.

We start with a description of the current situation. The most detailed and most recent sources for this are the 'Housing Survey 2005' and the 'Exterior Housing Inspection 2005', two high qual-

ity surveys with a response rate of respectively 67% and 98% carried out on behalf of the Flemish Minister responsible for housing in 2005 (Heylen et al., 2007). For assessing and understanding the evolutions over the past 20 to 25 years, we compare the results of these surveys with earlier survey and Census data. Next, we evaluate the situations in terms of the three main objectives of Flemish housing policy. In the final part of this article we will elaborate on the policy discussion.

2. The private rental market in Flanders

2.1 A shrinking market

According to the most recent data, the private rental market in Flanders represents 18.4% of the total housing market, what is approximately 460,000 dwellings. Nearly three-quarters (74.4%) of Flemish families occupy their own house, 5.4% rent a social dwelling and 1.5% occupy free accommodation (Heylen et al., 2007).

Formerly, the rental market was the largest sub-market in Flanders. But, as table 1 shows, the share has become smaller and smaller ever since. Separate figures for the private and social rental market are not available for the period before 1981, but on the basis of the figures for new construction of social dwellings in the post-war period (Deschamps, 1997) it can be assumed that the proportion of social rental dwellings was no greater than it is today, and probably even considerably smaller. Thus estimates suggest that the private rental market represented at least half of the housing market just after the War.

The percentage of owner-occupied dwellings has increased proportionately since then. In Flanders,

this is usually regarded as a success story, since home-ownership is an ideal for almost everyone. In the Housing Survey 2005 (Heylen et al., 2007), 49.7% of all tenants replied that they wanted to own their own home one day. It is seen as a good financial investment in the future. The desire to become a home owner rises with income and is greater if there are children. The detached home situated on the edge of the city is the most popular choice for ownership (Doms et al., 2001).

Yet this growing proportion of owners is not an unmitigated success, because not all income groups turn out to be progressing at the same rate. Figure 1 shows that the percentage of owners among the active population has only increased in the two highest income quintiles (quintiles 4 and 5). In the second and third quintiles, the proportion has remained approximately the same. In the lowest income group (quintile 1), we see a decrease, although this seems to have stopped since 1997. Yet the percentage of owners in 2005 is 10 percentage points higher in the second income quintile than in the lowest quintile.

The share of the private rental market is higher in urbanised areas than in rural areas. More than half of the private rental dwellings (55.4%) are apartments. In this, the private rental market clearly deviates from the rest of the housing stock, which is dominated by single family dwellings (80.0%). Private rental dwellings on average are also older than other dwellings.

2.2 Owned by many small landlords

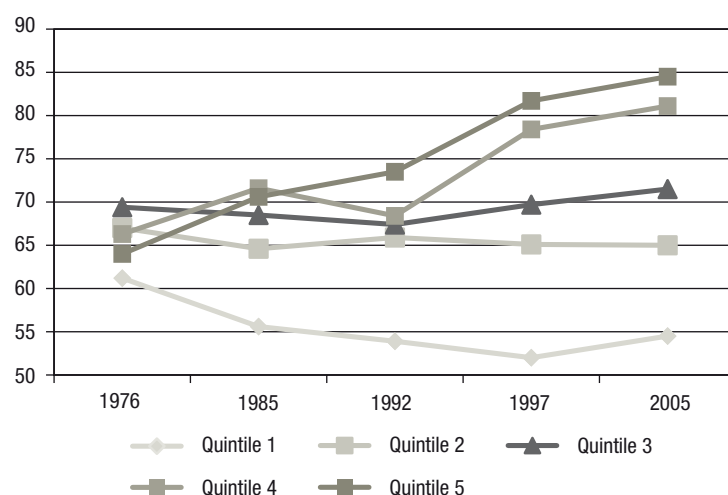
There is relatively little professional letting in Flanders: 94.4% of all private rental dwellings are held by private owners. Where dwellings are let by companies, it is rarely as a main business activity, but rather involves the letting of a few

¹ The author wishes to thank Kristof Heylen (HIVA) for the additional calculations on the Housing Survey 2005 that were used in this article.

Table 1: Occupancy status, Flemish region, 1947-2005

	1947*	1961*	1970*	1981**	1991**	2001°	2005°°
Owner	41.5%	55.5%	59.9%	65.6%	68.9%	72.6%	74.4%
Tenant	58.5%	44.5%	40.1%	32.6%	29.5%	25.8%	24.1%
> Private tenant						20.5%	18.5%
> Social tenant						5.3%	5.6%
Free accommodation				1.8%	1.6%	1.6%	1.6%

Source: * Descamps (1997), **Goossens et al. (1997), ° FOD Economie (Federal Economy Department) - ADSEI, SEE 2001, °°Heylen et al. (2007).

Figure 1 Change in the proportion of home-owners among active households (head of family younger than 65 years) by equivalent household income (in quintiles), Flemish Region, 1976-2005.


Source: Heylen et al. (2007)

dwelling as part of a large property complex. The two residential real estate investment companies operating on the private housing market in Belgium mainly let properties in the Brussels region. Flanders has no tradition of pension funds or insurance companies also investing in residential property as a means of diversifying their portfolio of assets (Vandenbroucke et al., 2007).

In 2005, private landlords in Flanders let an average of 2.2 dwellings. The majority (60%) let 1 dwelling. As a result, the housing stock is fragmented among 180,000 small owners. Often, the dwellings are acquired through inheritance. But there are also private individuals who delib-

erately invest in residential property with a view to letting. Especially self-employed regard the rent they receive as a means of supplementing their professional income, and especially their pension. Also retired persons are overrepresented among landlords (Vandenbroucke et al., 2007).

Around two-thirds of private tenants rent directly from a private landlord. The remainder rent via an estate agency. According to the Professional Institute of Estate Agents (BIV), this form of intermediation is on the increase. It is striking that dwellings let with intermediation are of higher quality than the other (Vandenbroucke et al., 2007). A particular form of intermediation

between tenants and landlords is provided by the 'social rental agencies' (see policy discussion).

There are relatively few disputes between tenants and landlords in the private rental market. In 2005, 43.9% of private tenants regarded the relationship as very good, and 40.1% as good. Only 3.3% regarded it as poor or very poor. When private tenants were asked whether they had ever had a dispute with the current landlord, 23.7% answered in the affirmative. The main source of disputes turned out to be the carrying out of repair work. Also landlords regard the relationship with their tenants as very good (45.3%) or good (41.8%), with only a few describing it as poor or very poor (4.3%). When there were disputes the main source was the payment of the rent (Vandenbroucke et al., 2007).

A significant proportion of landlords reported that they select tenants. To the question of what the landlord would do about a prospective tenant who was dependent on a rental guarantee from the OCMW (Social Welfare Centre), 41.4% answered that they would look for another tenant and 16.9% that they regarded this as a less preferable option, but that they would accept the tenant. The same figures for prospective tenants of non-Belgian origin were 27.0% and 31.3%, and even for single parents, the figures were 10.8% and 12.8% respectively. These figures probably underestimate reality.

By way of explanation for their selection behaviour, the landlords' organisations refer to the risks associated with private letting due to tenants' weak socio-economic profile. They state that the tenants' incomes are too low to charge a rent which provides a sufficient return on the let. Good return calculations for Flanders are not available. Vandenbroucke et al. (2007) perform a number of simulations under various hypotheses. In the basic scenario, the return on a private let (value addition included) in 2005 is calculated at 4.26%, which is less than the return on a risk-free investment such as a government bond. The return purely from rental income is barely 1.61%.

2.3 With an on average weak group as tenants

That private tenants on average show a rather weak socio-economic profile, can be seen in table 2.

First, the table shows that there is a significant income difference between the three groups. On average, the equivalent income² is highest for

² The equivalent income corrects the income for the size of the household.

owners. The same is expressed in the distribution by quintiles: the proportion of owners rises from 63% in the lowest quintile to 85% in the highest quintile. Private tenants are over-represented in the three lowest quintiles. But the social tenants have the lowest equivalent income.

In comparison with social tenants and owners, private tenants' on average are younger. This is probably because for a part of the private tenants' group renting is only a temporary situation on their way to home-ownership (see further).

Having paid work is a significant factor in home ownership. The percentage of owners is noticeably higher when there are two working people in the household than when there is one. The reverse picture is seen on the rental market. Above, the unemployed and the sick or unfit for work are over-represented on the rental market, in both the private and the social submarkets. In the case of private tenants, households with just one working person are over-represented, whereas those with two earners are under-represented.

There are also significant differences according to household type: couples with and without children are mainly found on the property market, whereas single people and one-parent families are over-represented on the private and social rental markets. And finally, non-Belgians, both those from the EU and others, are heavily over-represented on the private rental market.

All these characteristics are closely related. Using multivariate analyses, Heylen et al. (2007) observe that also *ceteris paribus* each of these characteristics has a distinct influence on the chance of becoming a home-owner.

3. The private rental market in Flanders evaluated in terms of housing policy objectives

The main purpose of the Flemish housing policy (see further) is the enhancement of decent and affordable housing with sufficient residential security, especially for weak groups. Therefore, we evaluate the situation in the private rental market starting from three objectives: housing quality, housing affordability and residential security.

3.1 Housing quality

During the last decades, a clear improvement in housing quality has been observed on the Flemish housing market in general (Vanneste et al., 2007; Heylen et al., 2007). This improvement is ascribed to ongoing (although diminishing) new construction and to housing renewal that in many cases accompanies acquisition on the second-hand

Table 2: Differences between socio-economic characteristics of private tenants, social tenants and owners, Flemish Region 2005

	Tenants			Owners
	Private	Social	Total	
Equivalent income quintiles (%)				
1	20.1	14.4	34.5	63.1
2	21.1	7.7	28.8	69.1
3	22.1	4.9	27.0	71.9
4	16.8	1.5	18.3	80.9
5	13.2	0.4	13.6	85.1
$\chi^2 = 283,3$; $p < 0,0001$				
Average equivalent income (in euros)	1,251	913	1,170	1,496
T=24,9; $p < 0,0001$ for difference private tenants/owners				
Average age	47 years and 9 months	57 years and 6 months	50 years and 1 month	54 years and 5 months
T=11,5; $p < 0,0001$ for difference private tenants/owners				
Activity status of reference person (%)				
Employed	19.0	3.0	22.0	76.7
(Early) retirement	14.1	7.0	21.1	77.2
Unemployed	36.4	17.3	53.7	45.7
Sick leave/work disability	25.7	15.4	41.1	56.7
Other	24.6	11.5	36.1	60.6
$\chi^2 = 247,7$; $p < 0,0001$				
Number of working people in household (%)				
None	19.2	9.8	29.0	71.0
1	26.9	5.6	32.5	67.5
2	13.6	1.2	14.8	85.2
$\chi^2 = 209,4$; $p < 0,0001$				
Household type (%)				
Single person	30.7	8.5	39.2	57.8
One-parent family	29.0	12.9	41.9	57.7
Childless couple	15.0	4.1	19.1	80.1
Couple with child	9.9	3.2	13.1	85.8
$\chi^2 = 402,4$ $p < 0,0001$				
Nationality of reference person (%)				
Belgian	18.1	5.4	23.5	75.0
Non-Belgian, EU citizen	28.3	4.1	32.4	66.3
Other	30.3	33.1	63.4	33.7
$\chi^2 = 88,1$; $p < 0,0001$				
Total	18.5	5.6	24.1	74.4

Source: Heylen et al. (2007) and additional calculation Kristof Heylen on Housing Survey 2005

Note: households occupying housing for free are omitted from the table, which is why the row totals do not add up to 100%

market (Winters & De Decker, 2009). Due to the lack of comparable data for the past, this general observation cannot be expressed in figures for construction quality or living space, but only for facilities. Table 3 shows the change in the level of facilities of private dwellings. In 1981, still 28.7% of dwellings lacked 'basic facilities', whereas

dwellings in this category were only found in exceptional cases in 2005. More than two-thirds of Flemish dwellings in 2005 had 'good facilities', i.e. running water in the home, flush toilet in the home, bathroom or shower, central heating, a kitchen of at least 4 m², a telephone connection and at least one car. It must be recognised that

this definition of 'good quality' is not very much up to date with modern standards.

The improvement in facilities has been greater in the rental sector than in the home ownership sector (Winters & De Decker, 2009). However, the quality of private rental sector still compares unfavourably compared with the rest of the housing stock. Three different indicators point in the same direction. According to the Exterior Housing Inspection 2005, the exterior condition of 94.6% of owner-occupied dwellings was regarded as 'good', compared with 91.5% of private rental dwellings and 95.9% of social rental dwellings. According to an indicator for 'physical condition of the dwelling' (Vanneste et al., 2004) based on answers from respondents in the Housing Survey 2005, the differences are even greater: 71.2% of owner-occupied dwellings were rated as 'good', compared with 45.9% of private rental dwellings and 56.1% of social rental dwellings. Finally, based on a more modern facilities indicator (Vanneste et al., 2004) than the one used above, 6.1% of private rental dwellings is rated as 'inadequate' against 1.9% of owner-occupied dwellings and 2.7% of social rental dwellings (Heylen et al., 2007).

3.2 Housing affordability

The current debate in Flanders concerning affordability of housing mainly focuses on prices. Apart from a stabilisation of prices during the last years, real estate prices in Flanders indeed have shown permanent and sharp increases. Nominal prices for dwellings rose from 28,338 euro in 1976 to 203,709 euro in 2008. As figure 2 shows, in real terms price increases were less sharp and during the first half of the 80's there even was a decline. However, from then on, a steady growth can be observed.

Over the period 1976-2008, rents have not increased at the same rate as dwelling prices. We only have figures for some years during this period, but these seem to show that rents were not as volatile as dwelling prices. While real dwelling prices declined during the 80's, rents increased. But the strong increase in dwelling price during the last decade did not result in comparable increases of rents. Part of the explanation is that rents in this figure are average rents paid by all households on the rental market and not only rents for new contracts. As will be explained further, during a rental contract rents cannot be raised to keep up with market conditions.

In 2005, the average rent for a private dwelling in Flanders was 431 euro, considerably higher than the average rent for a social dwelling (258 euro) or the payments made by owners on outstanding mortgages (564 euro). All this explains why

Table 3: Facilities of occupied private dwellings, Flemish region, 1981, 1991, 2001, 2005

Facilities	1981*	1991**	2001**	2005***
Basic facilities lacking	28.7%	13.9%	4.9%	3.3%
Basic facilities	22.4%	27.1%	25.0%	17.8%
Moderate facilities	20.1%	16.6%	14.0%	10.4%
Good facilities	28.8%	42.4%	56.0%	68.5%

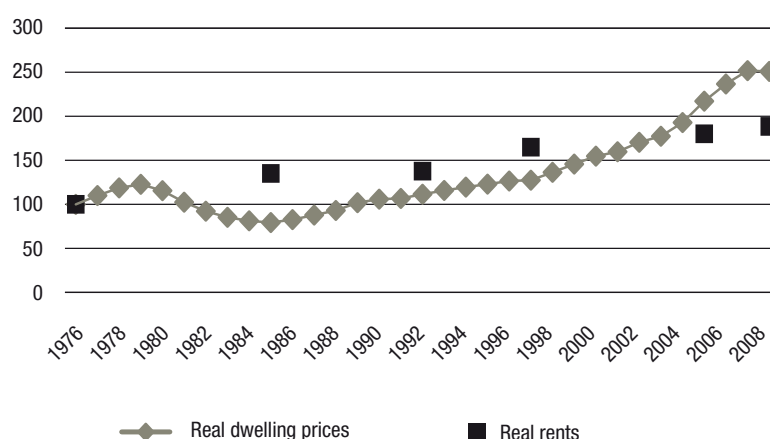
Source: * Goossens et al. (1997), **Vanneste et al. (2007), *** Heylen et al. (2007).

Basic facilities = running water in the home, flush toilet and bathroom or shower

Moderate facilities = basic facilities + central heating

Good facilities = moderate facilities, kitchen of at least 4 m², telephone connection and at least one car.

Figure 2 Real dwelling prices* and rents, Flemish region, 1976-2008, index 1976=100**



Source: FOD Economie – ADSEI, Heylen et al. (2007), own calculations

* Weighted averages for apartments and single family houses

** Social and private rents, based on survey results for 1976, 1985, 1992, 1997 and 2005; estimations for 2008 based on Belgian rent price index

the debate about the affordability of housing in Flanders is mainly focused on the cost of acquiring one's own home, and that in policy terms too, considerable importance is attached to supporting home acquisition.

The discussion on housing affordability however cannot be held in terms of prices only. Although there is no generally accepted definition of 'housing affordability', the definitions found in the international literature always make reference to the relationship between the cost of housing and household income.

"Affordability expresses the challenge each household faces in balancing the cost of its actual or potential housing, on the one hand, and its nonhousing expenditures, on the other, within its constraints of its income" (Stone, 2006)

A first method to measure housing affordability is the rent-to-income ratio. In 2005, private tenants spent an average of 29.5% of their income on rent, compared to 22.3% for social tenants. Home owners still paying of a mortgage spent 21.7% of their monthly budget on the payment. When we take 30% as a possible and in Flanders generally accepted standard for the rent-to-income ratio, 39.2% of the private tenants exceed the norm, against 17.1% of the home-owners and 12.2% of the social tenants.

Figure 3 shows that formerly the differences between the housing markets were not yet particularly pronounced. Since 1995, the average rent-to-income ratio for social tenants and owners increased slightly, whereas that for private tenants rose considerably.

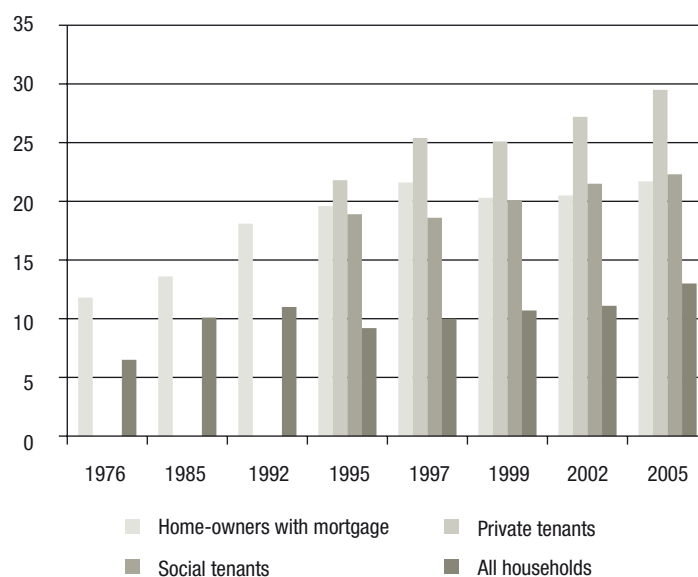
Figure 4 makes it clear that the underlying explanation for this change lies in the change in incomes. In real terms rents and mortgage payments changed at approximately the same rate over the period 1976-2005, both of them doubling. But whereas the average income of tenants since 1992 has fallen, that of owners has risen considerably, which explains why affordability in terms of average rent-to-income ratios has evolved less favourably for tenants than for the owners. De Decker et al. (2008) make the same observation on the basis of the change in equivalent residual income, another indicator for affordability that draws the relation between prices and income.

3.3 Residential security

Residential security can be defined as 'the possibility of continuing to live in the dwelling for as long as the occupier wishes'. For home-owners and social tenants, residential security is virtually total. In the private rental market, residential security is mainly determined by rental legislation (Winters & De Decker, 2009). The Housing Rental Act of 13 April 1997 stipulates that in principle, a rental agreement relating to a main place of residence should be concluded for a period of nine years. Departures from this principle are possible provided a written contract is entered into for a maximum period (including one extension in writing) of three years. If neither of the parties cancels the short-term rental agreement with a notice period of three months before the expiry of the short term, the rental agreement is converted into a nine-year rental agreement. However, departures from this principle are possible and frequently applied. For nine-year contracts the period of notice for ending the contract for the tenant is three months. For the landlord the period of notice is six months and notice is only allowed in exceptional circumstances. In case of violation charges apply. However, not all tenants are aware of their rights or are able to enforce their rights. Following Elsinga et al. (2007) rent regulation in Flanders is halfway between general regulation and total freedom.

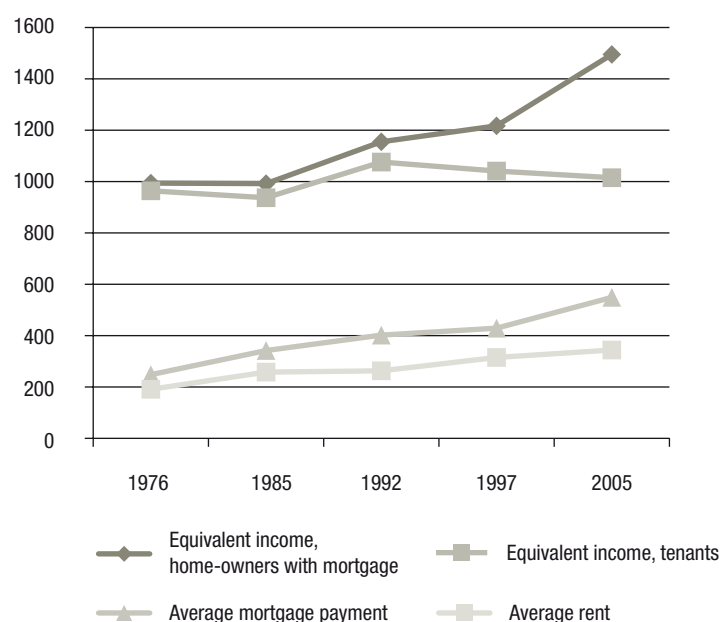
The duration of the rental contracts and the actual length of stay in the dwelling can offer some indication for residential security. In 1997, private tenants had already stayed in their present dwelling for an average of nine years (Pannecoucke et al., 2001). In 2005, the average length of stay so far had dropped to six years (Heylen et al., 2007). However, a short stay does not necessarily mean weak residential security, since it can also be the wish of the tenant.

Figure 3 Average rent-to-income ratio, by occupancy status and tenant type, Flemish Region, years 1976, 1985, 1992, 1995, 1997, 1999, 2002 and 2005



Source: Heylen et al. (2007), based on Housing Survey 2005; PSBH '95,'97,'99 and '02; SEP '76, '85 and '92

Figure 4 Change in equivalent income and housing expenses for home-owners with a mortgage and tenants, averages in euros, prices of 2005, Flemish region, 1976-2005.



Source: Heylen et al. (2007), based on Pannecoucke, De Decker & Goossens (2003) SEP, Flemish Housing Survey 2005

In the Housing Survey 2005 private tenants themselves were asked what they thought about their residential security. Slightly over 1 in 10

tenants described themselves as 'unsure' or even 'very unsure' of whether they would be able to carry on living in the same dwelling.

The difference with a higher residential security as perceived by social tenants is significant (Winters & De Decker, 2009).

The most acute issue in terms of residential security is that of evictions. The Public Welfare Centres reported that each week around 100 Flemish households face a situation in which their landlord starts proceedings with the Magistrates' Court to get the tenant evicted from the dwelling, a figure which is increasing rapidly. Recurrent failure to pay the rent and problems with the maintenance of the dwelling or nuisance caused to neighbours are virtually always the reasons for eviction proceedings (Verbeeck, 2005).

3.4 A segmented market

The average picture of the private rental market hides the diversity behind. In fact the private rental market in Flanders contains a number of segments, serving different groups. Based on cluster analysis Le Roy et al. (2008) demarcate three segments of which only one can be considered as problematic because of a low housing quality and the weak position of the tenants. Le Roy et al. estimate that this segment accounts for more or less than one third of the private rental market. Other groups on the private rental market are starters on the housing market, for whom renting is just a temporary situation on the way to home ownership. Some older persons move to private rental apartments because these fit better with their changing needs, while growing older.

Based on standards for what is regarded as the minimum acceptable level of housing quality and affordability, Winters et al. (2007) calculate that in Flanders approximately 180,000 households on the private rental market (this is 7.2% of all households) lack what can be regarded as a decent, affordable home. In view of the standards and the method used, this is a very rough but also a rather conservative estimate.

4. Policy discussion

4.1 Brief overview of the Belgian and Flemish housing policy for the private rental market

Housing policy originated in Belgium at the end of the 19th century. Right from the time of the first housing law of 1889, the main policy focus was on home-ownership. Behind this policy choice lay the Catholic Party's vision of ownership of a single-family dwelling as important for a stable family situation. The State provided a number of

tax incentives to stimulate the construction of workers' dwellings, premiums were introduced for the construction and purchase of dwellings and the State provided cheap loans for the purchase of homes by large families. The Socialist's on the other hand advocated the construction of social rental dwellings. However, the impact of social rental housing was relatively limited. Even when, after the Second World War, housing policy throughout Europe gained a role in reconstruction and as an instrument against economic depression, Belgium primarily opted to stimulate the construction of private housing (Goossens, 1982; Deschamps, 1997; De Meulder et al., 1999).

In 1980, the authority for housing policy was transferred from the Belgian state to the three regions: Flanders, Brussels and Wallonia. The legal cornerstone of the regionalisation process was the Flemish Housing Code of 15 July 1997. The Housing Code starts from the constitutional right to decent housing. The ultimate goal is to turn this right into a reality by promoting the availability of suitable dwellings, of good quality, in a decent residential environment, at an affordable price and with residential security. The Housing Code also gave priority to people with the highest needs. No longer were economic policy objectives dominating housing policy, but also territorial and categorical objectives came to the fore. New policy instruments were introduced and new actors gained recognition.

The new policy emphases were also expressed in budgetary shifts. An increasingly high proportion of spending was devoted to the rental sector. However, the largest share of this was spent on the construction of social dwellings. Support for private tenants remained extremely limited (Winters & Van Damme, 2004). Unlike most European countries, Flanders has no general housing allowance (Winters, 2005). There only is a financial contribution available for private individuals who move from a 'poor' to a 'good' private rental dwelling. For this reason, the allowance is also known as 'moving subsidy'. The contribution consists of a one-off relocation premium and a – except for elderly- decreasing monthly subsidy over a maximum of nine years. Elderly persons can receive it until dead. The system is targeted towards households with a very low income. Currently, 9,000 private tenants receive the allowance; about 2% of private tenants. The average rental subsidy is 185 euros per month.

An interesting type of organisations in Flanders are the social rental agencies (De Decker, 2002; De Decker, 2009). These organisations lease private dwellings and sublet them to vulnerable groups, prioritised according to need. The

Flemish government grants operating subsidies to these organisations. In 2007, the above mentioned 'housing allowances' were also made applicable to these letting. Also tenants' associations are recognised and subsidised by the Flemish government. These provide legal advice to all tenants (including social tenants) and defend tenants' interests.

Although full responsibility for housing policy lies at Flemish level, a number of policy instruments are still matters of federal responsibility, especially taxation and rental legislation. Housing taxation assigns benefits to home-owners for a budget which is many times the Flemish government's budget for housing policy (Doms et al., 2001; De Decker, 2000). The taxation system means that families in Flanders today are still being strongly encouraged to acquire their own home. Such incentives are not available for landlords letting private dwellings. And also housing renewal in the private rental market is not stimulated: real spending on this cannot be offset against taxable income.

Rental legislation (see also above) starts from the principle of contractual freedom (Dambre, 2008). The landlord is free to decide which tenant will rent the dwelling and at what price. Once the contract has been concluded, only annual adjustments based on the 'health index' are allowed. Since 1997, there is also a possibility to adjust the rent at the end of each period of three years in case of 'new circumstances' or if the landlord can prove that costs have risen more than 10%. At the start of the rental agreement the tenant should pay a bank guarantee. In 2007, the compulsory guarantee was reduced from 3 months' to 2 months' rent, in order to improve affordability for low income tenants.

The regulation of housing quality is mainly the responsibility of the regions. Minimum quality standards are laid down. If a dwelling does not meet the standards, administrative and legal action can be taken (De Smedt et al., 2007). Recently, several new measures concerning energy performance of rental dwellings came into force. The private landlords' organisation complains about the administrative burden the new measures imply.

4.2 The current policy debate

Over the past five years, the private rental market in Flanders has attracted attention in various ways. Several studies have pointed to the nature and seriousness of the problems. Whereas in the past the organisations which defend the interests of tenants and landlords often took opposing viewpoints, since 2005 these organisations have increasingly agreed on a joint analysis of

the problem, supported by scientific evidence. During a study day in the Flemish Parliament in April 2007 on the private rental market there was also found to be a high degree of unanimity between the large Flemish political parties. Both a policy aimed at increasing the supply on the private rental market and a demand-side policy in support of tenants were regarded as necessary. In the spring of 2009 the 'Werkgroep Huursubsidie' [Joint Rental Subsidy Working Group] with representatives of the private construction sector, the private landlords, the local authorities, organisations representing the poor, tenants' associations, social rental agencies and researchers wrote a joint paper on the private rental market and agreed on an urgent need for the introduction of a housing allowance as a fully-fledged pillar of Flemish housing policy. Based on figures concerning housing needs, the target group for such a general allowance was roughly estimated to be 195,000 households.

Despite this growing consensus, substantial initiatives towards the private rental market were largely non-existent during the most recent term of the Flemish government (June 2004 – June 2009). On the contrary, the main policy efforts were focused on bringing onto the market an affordable supply of houses and building plots for purchase and on the social rental sector. The above mentioned system of 'moving allowances' was adjusted and the target group was slightly extended, but this cannot be regarded as the introduction of a general housing allowance. Nor was the Flemish government's intention of stimulating supply via a government real estate investment company realised during the latest term.

There is little consensus between the stakeholders on the priorities for private rental legislation. Tenants' representatives are calling for improved protection and want at least a soft form of rental regulations to be introduced (Vlaams Overleg Bewonersbelangen - VOB, 2009). Representatives of the owners on the other hand stress that current rental guarantee regulations offer insufficient security against defaulting on payment, and are not in favour of any form of rent regulation (Algemeen Eigenaarsyndicaat [General Landlords Association] - AES, 2009). A possible compromise might lie in a system of 'target rents' based on 'objective prices'. Dambre (2008) has devised a legal blueprint for such a system. In 2009, the new Flemish Minister of Housing in her policy note announced the introduction.

Since September 2008, Flanders has been undergoing the economic and financial crisis as other countries. The landlords' organisation reports that this temporarily gave some relief to the private rental market, since households

were a bit more hesitant about buying their own home. This became visible in a stabilisation of dwelling prices. Recently however, dwelling prices started to increase again. Whatever the effect will be, the data shows that the need for good, affordable dwellings in the lower segment of the rental market is so great that even favourable developments in property markets will not alleviate it very quickly, and that a policy with regard to the private rental market will remain highly desirable.

5. Conclusion

Since the second world war, the share of the private rental market in Flanders has been in continuous decline. This development is the result of rising incomes, favourable market conditions and a policy of increasing home ownership. However, the downside of this development has become increasingly apparent in recent years. Survey results show that only households with higher incomes have been able to make the transition from private renting to home ownership. As a result, a growing socio-economic gap between the private tenants and home-owners can be observed. On the other hand, housing quality in the private rental market seems to be closing the gap with the owner-occupied market, but quality differences between the markets remain significant.

The weakening profile of private tenants makes letting a dwelling less attractive. The financial return on investing in rental housing is low compared with other investments. Landlords are showing negative selection behaviour in order to reduce the risks of not being paid. Moreover, housing renewal is not encouraged by the legal system and costs cannot be simply recovered by increasing the rents. Finding good and affordable housing for disadvantaged groups is therefore becoming more and more difficult. The social housing sector in Flanders is far too small to meet current needs.

A specific issue is that almost all private landlords in Flanders are private individuals letting an average of two or three dwellings. One out of three landlords is aged 65 years or older. As they get older, taking into account the low financial return on letting, the administrative burden and the high demand for owner-occupied housing, many landlords consider selling the dwelling, creating the risk of further negative developments in the private rental market.

Interest groups representing private tenants, home-owners and the building industry are insisting on the introduction of new policy instruments to stimulate the private rental market.

Although the Flemish government announced new policy initiatives during the last period of government, no significant measures have been taken so far. The new Minister of Housing is facing a serious challenge.

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Housing Finance in India: An Overview

By Renu Sud Karnad

1. Indian Economy

India has had a meteoric economic rise since its liberalisation in 1991. Prior to this, India's true economic potential had never been tapped. For three decades post India's independence in 1947, the economy was unkindly labelled as having a "Hindu rate of growth" signifying a slow and stagnated GDP growth rate of 3.5% per annum. This was primarily attributed to the protectionist and interventionist policies being pursued by the government at that time. While the trigger to the 1991 economic liberalisation and reforms process was a result of a balance of payments crisis, the real opening of the economy bore fruit over the last decade. Between the period 2003 to 2008, India's GDP averaged 8.9%. Economic liberalisation prompted a dramatic increase in foreign investment into the country, fostered an increased pace of privatisation and augmented domestic consumption. With services predominantly driving India's growth story, sectors like financial services, information technology and outsourcing and telecommunications catapulted India into a new league.

Moreover, what liberalisation did for India was to unravel its greatest strength - its demographics. 60% of India's population is under the age of 30 years. Increasing urbanisation, rising disposable incomes and better job opportunities has given rise to a new found confidence. As this generation strives for a better quality of life, key amongst their rising aspirations are to be homeowners.

India is a domestic driven economy. This is one of the primary reasons why the country remained unscathed from the global financial crisis. Despite the overall global slowdown, India remained the second fastest growing economy after China with a GDP growth of 7.4% for financial year 2010 (India's financial year ends on March 31). Since then, the economy continues to show resilience and is expected to return to its pre crisis GDP growth trajectory of 8.5 to

9%. The two fastest growing economies - India and China together, account for 40% of the world's population.

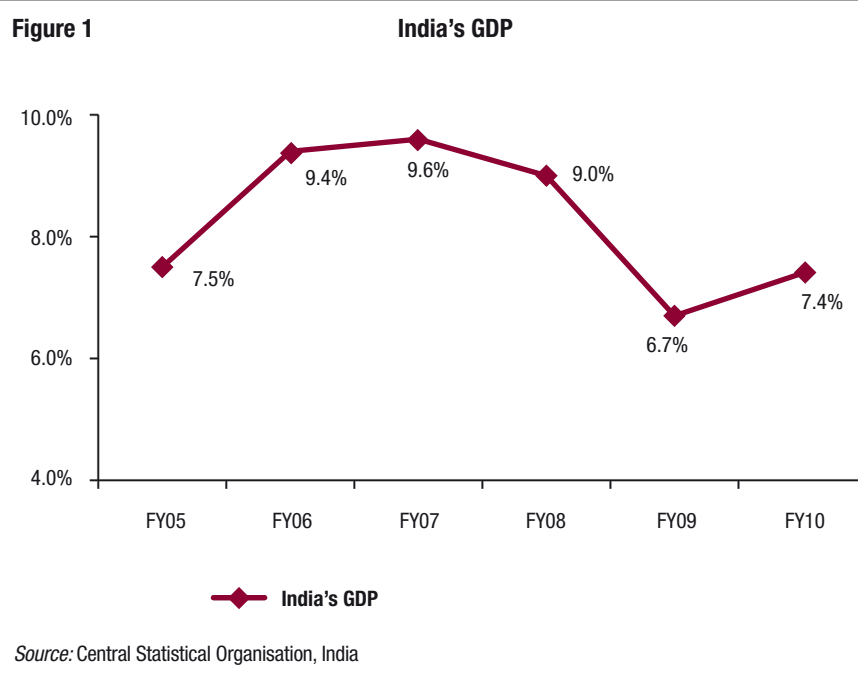
India, however, faces two key challenges that currently impede the country from attaining a higher rung of economic achievement - inadequate infrastructure and finding appropriate solutions for affordable housing. The housing shortage in India is acute 24.7 million dwelling units though unofficial estimates peg the shortage as high as 40 million. It is estimated that Rs. 5,100 billion (~US\$ 109 billion) is required between the period 2007 and 2012 for housing.

2. Urbanisation

India has seen a gradual, structural shift from an agrarian based economy to a services and manufacturing driven economy. Urban areas or cities are now at the centre stage of the devel-

opment process. Growing urbanisation not only represents a demographic shift in population but also signifies a social, cultural and economic transformation. Currently approximately 300 million people or 28% of India's population live in urban areas. According to a recent study by McKinsey Global Institute, by 2030, 40% of India's population or 600 million people will be living in cities. To put this number in perspective, it is twice the current population of the US. It is further estimated that 70% of India's employment will be generated from cities. To meet the growing demand, India will need to build between 700 million to 900 million square metres of residential and commercial space – equivalent to adding one Chicago every year! The growth of urbanisation critically depends on the necessary infrastructure to be in place to house, educate, transport and employ the moving masses. It is estimated that India needs US\$ 1.2 trillion capital investment over the next

Figure 1



twenty years to meet the projected infrastructure demands of its cities.

With rapid urbanisation comes an acute pressure on housing. Further, the demand for housing will only increase in the coming years as India's middle class is expected to rise to 800 million by 2020 from the current 250 million. Thus, the need for widening the reach of housing finance across India is critical. Housing also plays an important role in terms of the multiplier effect it has on the economy due to its strong backward and forward linkages with various industries and as a direct and indirect employment generator. Alleviating the urban housing shortage could potentially raise India's GDP by 1 to 1.5%, besides having a decisive impact on improving the basic quality of life.

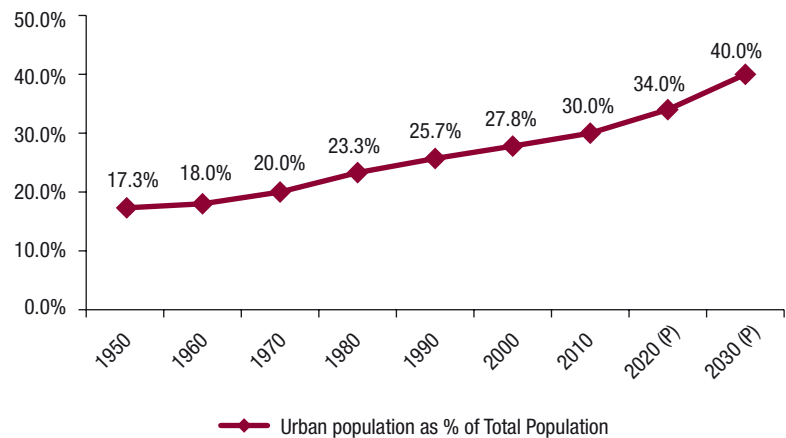
3. Evolution of Housing Finance in India

Until the 1970s, the government's support to housing was centralised and was directed through State Housing Boards and Development Authorities. In 1970, the central government set up the Housing and Urban Development Corporation (HUDCO) as a wholesale lender to finance housing and urban infrastructure activities. It was only in 1977 that the first retail housing finance company was established, Housing Development Finance Corporation - India (HDFC). When HDFC was launched, there were no foreclosure norms nor was there much access to long-term finance in India. Nonetheless, given the immense demand for housing finance and HDFC's emphasis on quality customer service, its success as a pioneer of housing finance in India served as a precedent for others to follow. In 1988, the National Housing Bank (NHB) was established as a 100% subsidiary of India's central bank, the Reserve Bank of India (RBI) to exclusively promote housing finance through a refinance mechanism and also to function as the supervisory and regulatory body for housing finance companies. Later in the late 1980s, other housing finance companies (HFCs) were launched by insurance companies, public sector banks and the private sector.

In the earlier years, commercial banks were reluctant to lend for housing and other retail loans as they preferred to finance the working capital needs of industry. Though several banks had set up housing finance subsidiaries, they mostly functioned as independent units with little support from their parent bank.

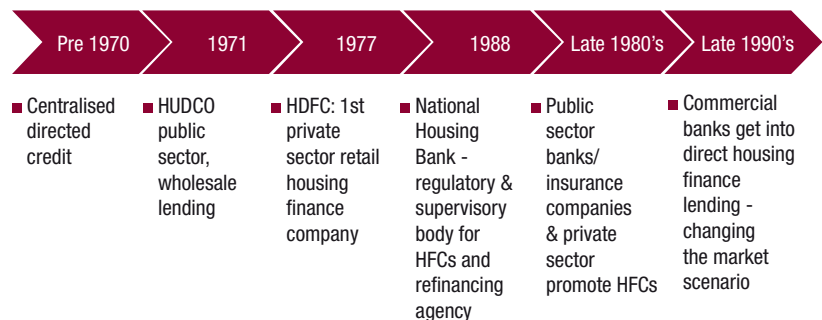
The turning point in the housing finance sector came in the late 1990s as commercial banks which had traditionally shied away from housing

Figure 2 Urban Population as % of Total Population



Source: Census of India 2001, HDFC Estimates

Figure 3 Housing Finance Timeline



Source: HDFC

finance, entered the market. Against a backdrop of low interest rates, industrial slowdown, sluggish credit off-take and ample liquidity, banks recognised that if they had to maintain their asset growth and profit margins, they needed to shift their focus from the wholesale segment and build their retail portfolios. Housing finance in India has traditionally been characterised by low non-performing assets. This together with the fact that there was a vast demand for housing loans resulted in many commercial banks getting into the business of housing finance. Today, banks and HFCs are both key players in the housing finance market, with banks accounting for 70% of the market share. However, the top four players comprising HFCs and banks account for close to two-thirds of the market share. Though mortgage penetration in India has more than tripled from 2% of the GDP in the late 1990's to 7% today, this ratio continues to remain low, especially when compared to other

Asian peers, where the ratio hovers between 12% to 25%. Thus, scope for the mortgage market to grow is immense.

4. Regulation of Housing Finance Players

The regulation and supervision of housing finance players in India is unique. The Reserve Bank of India (RBI) regulates the commercial banks while the National Housing Bank (NHB) regulates the Housing Finance Companies (HFCs). However, the NHB is a refinancing arm for both, commercial banks and HFCs.

There are fundamental differences between commercial banks and HFCs regarding taxation treatment, capital adequacy, liquidity requirements, deposit insurance and disclosure requirements. For instance, while banks are mandated to allocate 40% of their advances

for priority sector lending¹, of which housing finance qualifies, HFCs are not bound by sectoral lending limits. When banks lend under direct housing finance, a loan up to Rs. 2 million (~US\$ 42,550) qualifies for priority sector lending, however, when a bank does indirect housing finance, i.e. lends to a HFC for on-lending, a loan of only up to Rs. 500,000 (~US\$ 10,640) qualifies for priority sector. Further, under the housing finance allocation, banks are mandated to earmark at least 3% of their incremental deposits to housing finance, though today most banks are lending in excess of this mandated allocation. In terms of capital adequacy norms, banks are required to maintain a minimum capital adequacy ratio of 9% as compared to 12% stipulated by NHB for HFCs.

The advantages that banks have over HFCs is that they have access to low cost current and savings accounts while HFCs are only allowed to access term deposits with a minimum tenor of one year. On the other hand, HFCs typically have lower operating costs viz-a-viz banks.

5. Customer Profile

The typical average Indian middle class consumer continues to be relatively debt risk averse. Most borrowers are first time homebuyers acquiring a house for self-occupation. The loan to value ratio is rather low compared to many other countries since a borrower will prefer to first use his savings, borrow from friends and family and then opt for a loan. HDFC's customer profile is largely a salaried earner, the average loan size is Rs. 1.75 million (US\$ ~37,230) and the average loan to value ratio at origination is 67%. The average age of the individual borrower has come down significantly in recent times. Today, the average age of a homebuyer is 35 years compared to the mid 40s a decade ago.

6. Improved Affordability

One of the prime reasons why home loans have increased rapidly in the recent period is due to improved affordability. For instance, 15 years ago in India, it would take around 22 times a person's annual income to be able to afford a modest sized home in a metropolitan city. Today, this affordability has improved to 4.7 times one's annual income. Despite property prices rising, affordability has improved mainly due to sharp increases in the income levels of people.

Figure 4: Key Players in the Mortgage Market

Banks		Housing Finance Companies
Reserve Bank of India (RBI)	Regulator	National Housing Bank (100% subsidiary of RBI)
Access to low cost funds via current/saving accounts Extensive branch network	Advantages	Dedicated players, better customer service Lower operating costs
High operating costs Mandating direct lending, maintenance of cash reserve ratio & statutory liquidity ratio	Disadvantages	Higher funding costs Higher capital adequacy ratio

Source: HDFC

Secondly, the government's support towards housing is evident from the fiscal incentives provided on housing loans. Interest paid on a home loan is eligible for deduction to the extent of Rs. 150,000 (~US\$ 3,190) and the principal repayment is also eligible for deduction to the extent of Rs. 100,000 (~US\$ 2,130). These limits have been enhanced over the years. These tax benefits help to reduce the effective interest rate on a home loan.

7. Characteristics of Housing Loans

In India, housing loans are offered for a maximum of 15 to 20 years though on an average, the tenor at origination is about 13 years. Housing loans are repaid through equated monthly instalments, which consist of a principal and interest component. Thus the customer starts repaying the loan from the following month in which the housing loan is fully disbursed. Therefore, the lender begins to receive a part of the principal amount back as soon as the loan is fully disbursed. As a result, the effective duration of a housing loan gets reduced to around 7 to 7.5 years. Most Indians still prefer to repay their housing loans as soon as they can. For instance, when they get bonuses or any other windfall gain, many customers prefer to prepay their housing loans. This helps to further reduce the effective duration of a housing loan to about 5 to 5.5 years.

Until the late 1990s, the interest rates on housing loans were fixed. Once the banks got more

focused on retail housing finance, the market gradually changed to floating interest rates. With floating interest rates priced lower than fixed rates, most customers opted for floating rate housing loans. During the present decade, floating interest rates on housing loans have varied from a low of 7% to a peak of 12% p.a. Over the last eighteen months, customers have shown a strong preference for dual rate home loans, where interest rates are fixed for a predefined initial period after which the interest rate on the loan is floating. From a pricing perspective, the dual rate home loan works well when the yield curve is steep i.e. there is a significant difference between short and long term interest rates. Thus in the initial period when the interest rate is fixed, the rate is lower than in the subsequent period when it becomes a floating rate. Currently, however, there has been a flattening of the yield curve, with short term rates having hardened more than long term rates. Thus going forward, the pricing and attractiveness of the dual rate home loan product will hinge on the movement of the yield curve.

8. Marketing and Distribution

Marketing and distribution plays an important role in determining the growth of a housing finance player. With strong competition, housing finance in India is clearly a buyers' market. Earlier, word of mouth was the most effective means of reaching out to new customers. Today, customers are more discerning. Due to competition, housing finance players have to reach out to customers rather than vice versa. Banks

¹ Priority sector lending: Certain sectors of the economy require to be prioritized in terms of credit availability and thus banks are mandated to lend to specified sectors such as agriculture, small scale industry, housing etc.

have an inherent advantage of their large branch network, but the quality of service rendered may lack focus as housing loans are one of the many products being offered. Conversely, for a HFC, building up a large network is often time consuming and expensive. Technology and robust systems play a key role in helping players keep their operating costs at optimum levels.

An outcome of increased competition in the financial services industry has been the rise of Direct Selling Agents (DSAs) who provide door-step service. As competition intensified in the housing finance industry, several players handed over the reins of DSAs to increase their business. However, there have been instances wherein agents do not have the adequate information or expertise on housing finance and end up making disingenuous offers to consumers. Experience has revealed that it is prudent to use DSAs only to source loans, while the appraisal process should be done entirely by the lender. In India, there are no pre-qualifications mandated for DSAs selling home loans.

9. Sources of Funding for Housing Finance Players

While banks mostly rely on savings and current accounts to fund their housing portfolios, HFCs typically rely on diversified funding sources. In India, for many years long-term resources were not easily available. Earlier, one source of long-term funding was from multilateral agencies. For instance, HDFC, particularly in its early days was able to access resources from multilateral agencies such as the World Bank, the International Finance Corporation, the Asian Development Bank and the Commonwealth Development Corporation amongst others. Unless an institution has the expertise to manage the foreign exchange risk, such borrowings were not easy to handle.

In the 1980's and the early 90's, it was difficult to hedge a foreign currency liability and foreign exchange covers were available for up to a maximum of 6 months only. Fortunately, today there is far greater sophistication in the financial markets and it is possible to hedge foreign currency liabilities in a number of ways and for long periods of time through a variety of sophisticated hedging instruments.

Insurance companies typically look for long-term assets. In India, until 2000, there was only one government-owned life insurance company. This severely restricted the ability to tap long-term resources. However, post 2000, the Indian government privatised the insurance sector. Today there are 23 life insurance companies operat-

ing in India and these companies are growing rapidly. Insurance companies look to invest in long-term assets and as a result, there has been a considerable deepening of the long-term debt market as well. Needless to add, housing finance providers have benefited since they issue long-term bonds which are mostly subscribed by insurance companies and provident funds.

The other sources of funding that HFCs in India rely upon are loans from commercial banks. These tend to be of a shorter tenor. Housing finance providers also get medium to long term funding from the National Housing Bank under its refinance window.

Securitisation of mortgage loans is another source of funding, though it has not really taken off in India. Housing loans have to be seasoned for at least one year before the originator can securitise the loans. Buyers of mortgage-backed securities (MBS) typically hold on to these investments, hence the MBS market is still fairly illiquid.

HFCs in India, unlike commercial banks are not allowed to have current or checking accounts, but instead are permitted to issue term deposits with a minimum tenor of 1 year and a maximum tenor of 7 years. It is prudent for HFCs to have a mix of wholesale and retail funding. Typically, wholesale funds tend to be cheaper than retail funds since retail funds entail higher administrative and marketing costs. However, in a high or volatile interest rate environment and in times of tight liquidity, retail funds are a more stable source of funding.

10. Impact of the Global Financial Crisis

India was not directly affected by the global financial crisis because the exposure of Indian banks to complex securitised products was limited. Financial institutions in India are conservative and offer plain vanilla, amortising home loans. Furthermore, mortgage loans are given in India based on an evaluation of the cash flow of the borrower rather than based solely on the property value.

Indian banks have by and large been resilient throughout the financial crisis. Unlike many Western banks, which had toxic assets and complex securitised products, the credit quality of Indian banks continues to be of high quality. Even though bank credit grew by 30% per annum during 2005-07, there was no significant relaxation of lending standards. Further, to prevent the build up of speculative asset bubbles, the central bank had taken several

pre-emptive measures such as prohibiting banks from financing land transactions, raising risk weights and tightening provisioning requirements on commercial real estate loans.

India, however, was not completely decoupled from the global financial crisis. The collapse of Lehman Brothers in September 2008 resulted in a liquidity crunch in India. Confidence in the financial system had been shaken. Indian banks too turned risk averse, resulting in a credit freeze. This triggered a domino effect and the liquidity crunch affected several sectors including real estate.

It was particularly difficult for the real estate sector during the period October 2008 to March 2009 as many overleveraged developers found themselves on the brink of a disaster. Part of the problem lay with developers that had gone on a land-buying spree as they were flush with funds in the pre crisis period. A lot of money had come into housing and real estate through the foreign direct investment route. However, much of this funding was really high cost debt masquerading as equity. With the equity markets also crashing, resource raising became extremely difficult. Against a backdrop of rising interest rates and tightening liquidity, many developers had to resort to borrowing at very high interest rates to prevent defaulting.

Meanwhile negative economic sentiments also resulted in consumers preferring not to buy property. Since developers needed the cash flows and did not want to hold on to their unsold stock, residential property prices dropped by 20 to 25% across India. With property prices becoming more realistic, buyers returned back to the market. During this period, developers also shifted their focus from the luxury segment to the mid-market and affordable residential market where the demand is always high. The affordable housing segment offers the advantage of high volumes and shorter construction and sales cycles, which helps reduce the working capital requirements of developers.

Fortunately during this critical period, the central bank and government also undertook several swift measures to ensure stability in the financial system, which included providing special liquidity facilities, adopting counter cyclical prudential norms and to encourage home buyers, the government offered a 1% interest subsidy on home loans for houses costing up to Rs. 2 million (~US\$ 42,550).

As economic sentiment revived, the residential sector showed considerable improvement. Many developers now have much cleaner balance sheets and are less leveraged. However, post

December 2009, residential real estate prices have once again rebounded, surpassing peak levels of 2007-08. Residential real estate prices in certain pockets of the country have touched unsustainable levels, though the demand for housing continues unabated.

11. Affordable Housing: Challenges & Opportunities

Greater emphasis needs to be placed on increasing the supply of affordable and low cost housing. In India, low cost housing is primarily aimed at Economically Weaker Sections (EWS) and Low Income Groups (LIG) and both these segments need intervention and support from the government. Households having an income less than US\$ ~110 per month are termed as EWS, while LIG are those that have an income that is greater than US\$ ~110 per month and up to ~US \$ 210 per month.

Defining affordable housing is a challenge. Affordability has to factor in various facets - location, household income, spending and saving patterns and demographic factors like the size of the household. Clearly a one-size-fits-all approach does not work, but broadly, in

the Indian context for housing affordability, the cost of a house should not exceed 4 to 5 times the annual household income and the rent or loan instalment should not exceed 30 to 40% of the monthly household income.

The high cost of land in cities is one of the greatest hindrances in providing affordable housing. At the lower income level, slum rehabilitation schemes through public private partnerships have worked well in some pockets. This scheme entails a vertical development of the slum sprawl with the developer being allowed a higher floor space index (FSI). The developer provides slum dwellers with permanent structures - typically a one-room tenement with an attached bathroom free of cost, while the developer benefits from the surplus land, which can be used for commercial purposes.

The other problem with affordable housing is that if it is built in far flung city outskirts where the land may be cheaper, there are often no takers for such homes since the necessary infrastructure in terms of mass rapid transportation systems, schools, hospitals and other civic amenities may not be available. To make affordable housing a reality, key stakeholders

have to ensure that infrastructure and housing development happens simultaneously.

12. Rural Housing

Within the low-income group, housing problems in the urban and rural areas are vastly different. For instance, housing remains unaffordable to a vast population in urban areas due to distortions in land prices. On the other hand, in rural areas, housing inadequacy is reflected in the mismatch between desired and actual housing quality. The requirement of housing finance in rural areas is predominantly for the upgradation of houses - especially for improving basic amenities such as access to drinking water, sanitary facilities, cooking space and better power connections.

Given that rural areas account for 70% of India's population and 57% of the housing shortage in India, rural habitat development is crucial for the sustainable and inclusive growth of India. While several initiatives have been taken by the government in terms of various schemes for the provision of rural housing, owing to the scale of the problem, they have not always yielded the desired results and hence there is a need for greater intervention.

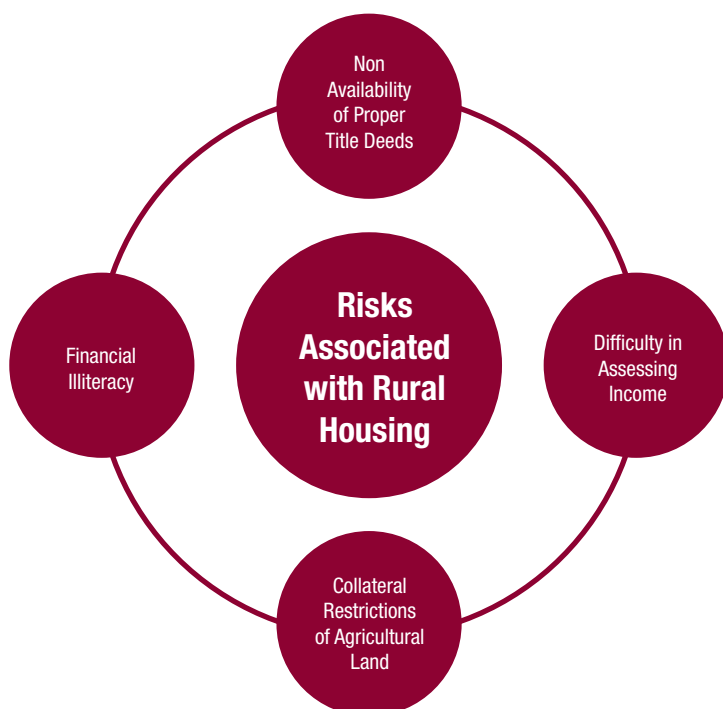
One of the major constraints associated with rural housing is the non-availability of tangible security for housing loans. Rural lands are often fragmented, which has resulted in conflicting records of land owners and non availability of title deeds. There are further complications due to restrictions of ownership, usage and transfer of agricultural land. The biggest hindrance is the restriction on taking agricultural land as collateral for lending for non-agricultural purposes.

Other challenges with rural housing include difficulties in estimating the level of income of borrowers - particularly agricultural income which fluctuates, depending on the vagaries of the weather. However on a positive note, the rural economy is seeing a distinct shift away from the predominance of agriculture. It is estimated that over 35% of rural households are now engaged in non-agricultural activities.

Despite the formal sector's attempts to make in-roads into rural financing, informal sources of finance continue to dominate. In fact, in the lowest income groups, over 70% of loans are taken from moneylenders and relatives/friends. Needless to say, moneylenders continue to be exploitative and charge usurious interest rates. Formal finance options are still few. It is estimated that rural housing finance credit forms only 11% of the housing loan portfolio of commercial banks.

Figure 5

Rural Housing Constraints



Source: HDFC

13. Financial Inclusion: the way forward

In India, there is now a growing recognition that the country's aspirations towards achieving a sustainable double digit growth rate can only happen if there is a complete commitment to financial inclusion. This necessitates an integrated financial infrastructure which will ensure that all segments of the population get access to the formal financial sector. Financial inclusion will catapult India into the next wave of economic prosperity. Providing effective housing finance solutions across all income segments will form a crucial component of India's financial inclusion agenda.

Housing finance players, policymakers and other stakeholders need to work together and strive towards the challenge of housing more people in India. The provision of housing finance is a logical extension of the "Fortune at the Bottom of the Pyramid". This is because nothing can be more beneficial to a nation than a property owning democracy. A successful and sustainable existence of civilised society depends on having the greatest possible number of people who have a stake in society. Being a homeowner gives one a secure and direct stake in society. Thus housing more individuals must form one of the most important goals of the country.

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