

SEPTEMBER 2007

HOUSING FINANCE INTERNATIONAL

*The Quarterly Journal of the
International Union for Housing Finance*



Financial Stability Risks

*plus Managing Mortgage Arrears, Increasing
Affordability Problems, the Rise in Debt
and Opportunities and Risks
in Afghanistan.*



HOUSING FINANCE INTERNATIONAL

Vol. XXI No. 5 SEPTEMBER 2007

Housing Finance International is published four times a year by the International Union for Housing Finance

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Editor's Introduction

by Friedemann Roy

According to Patrick Artus from Natixis Bank, global economic growth is expected to slow down by 0.6 to 0.7 per cent in 2008 due to the subprime loan crisis in the US¹. The current turbulences in the international financial markets clearly indicate the growing interdependence of local housing markets. This development also shows the need for a broader conception of housing market governance by national regulators such as central banks and for a closer co-operation of these regulators on an international level.

Our first article written by Jacob Gyntelberg, Martin W Johansson and Mattias Persson is aimed at providing further insight into this topic. They point out that the last ten years have seen considerable growth in housing finance activities, ie in both house prices and household indebtedness in many developed and emerging economies. Although maturing housing finance markets have been broadly welcome, these developments have also raised concerns about housing finance related credit risks and financial stability. These concerns have been re-emphasised by the recent financial market turmoil which has been linked to losses in the US sub-prime market. In their article, they provide an overview of how selected central banks have used micro-data to assess risks to financial stability stemming from housing finance markets.

The second article by Mark Stephens and Deborah Quilgars complements the discussion commenced during the first one since they focus on behavioural patterns of borrowers in arrears. Their findings are based on a survey that provides a detailed profile of home-owner arrears and possessions, and lenders' policies and procedures towards them. Results show that the different risk profile of the prime and non-prime mortgage market sector is reflected, for example, by the higher rate of arrears in the non-prime sector. The value of this survey lies in the collection of existing

experiences and practices that could help the housing finance industry to better deal with subprime borrowers.

The next article is by Christine Whitehead and Judy Yates. They analyse the prospect of shared equity products to support access to housing. A shared equity product allows for the division of the value of the dwelling between more than one legal entity. After discussing the rationale for these products, they describe recent development in Australia and the United Kingdom which appear to be the most active markets in this product category. In their conclusion, they provide a detailed analysis on their benefits and risks.

The work by Nathalie Girouard, Mike Kennedy and Christophe André relates to the first article of this edition. Their research focuses on the question of whether the rise in household debt has made this sector as a whole more vulnerable to economic shocks. They found out that the major part of debt is held by higher-income households, who also spend a smaller proportion of their disposable income on debt servicing. Lower-income households, with less ability to service debt, do not hold that much and, as such, the spill-over effects from this group to the rest of the economy are probably not large. Apparently, the current turmoil of the US subprime market points into a different direction. This paper is based on a working paper published by the Organisation for Economic Co-operation and Development (OECD). The data delivered appear as a welcome contribution to the current debate in the media.

Our next two articles deal with housing markets in Asia. The first article, by Garth Bedford, is about the very nascent market in Afghanistan. It summarizes the results of a housing sector assessment workshop held by the International Financial Corporation (IFC) in March 2007. Market development is not only

stalling due to the continuous warfare in the country. One of the other main hurdles is the disruptive and cumbersome title regime which is based on several, sometimes contradictory, laws and local regulations or court rulings.

The second article is by Dr P Saravanan. It provides an insight on the Indian housing finance market. The need for more housing is mainly driven by population growth (including increasing household formation due to the young population) and rising urbanisation. Income increases and lower interest rates have favoured housing affordability, in particular for middle income groups. Overall conditions and the positive outlook for the Indian economy underline the potential of the housing finance market.

The penultimate contribution relates to an article by N O Jorgenson published in the March 2007 edition (*"Housing the No-Income Group"*). He explained a model which could provide better access to housing to poor and low income groups. Ann Jennervik provides a comment on this article. She underlines the need for more action to work on better housing standards for this group which still appear to be neglected or only randomly taken on.

Finally, we feature an article on developments in Nigeria. Modupe M Omirin and Timothy Gbenga Nubi, both Senior Lecturers in the Department of Estate Management at the University of Lagos, Akoka, Lagos provide a clear analysis of the growth of the Nigerian housing finance market, the current difficulties it faces, and their proposals for overcoming those problems.

If you would follow Ann Jennervik's example and provide feedback on one of the articles presented in this edition or a previous one, this would be more than welcomed! I look forward to your comments or recommendations.

¹ Le Monde, "Le monde va perdre 6 ou 7 dixièmes de point de croissance en 2008", 28 August 2007.

Using Housing Finance Micro Data To Assess Financial Stability Risks*

by Jacob Gyntelberg[†], Martin W Johansson[‡] & Mattias Persson[§]

1. Introduction

Since the mid-1990s, house prices have risen rapidly in a number of both industrialized and emerging economies. In many countries the upswing in house prices has lasted longer and has been sharper than in previous boom periods. Over the same period many countries have seen a visible increase in housing finance related debt, while interest rates have declined and debt servicing costs have remained relatively stable. In addition, the use of more complex mortgage types such as adjustable rate type mortgages with embedded options as well as hybrid loans that combine variable and fixed rate elements has increased. Concerns about the sustainability of these developments have prompted central bank efforts to assess the potential financial stability implications.

In this article, we consider some of the central bank efforts to use of micro data to assess the possible financial stability implications of developments in housing finance markets. In the following section we consider global developments in house prices and household indebtedness. In the third section, we briefly suggest some possible drivers behind these developments. In the fourth section, we discuss central bank approaches to gauge financial stability risks stemming from housing finance developments, including in particular approaches based on micro data. The final section provides some concluding thoughts.

2. Recent Developments

2.1 House Prices

Real house prices have increased significantly over the past two decades. House prices have never before risen so fast, for so long, and in so many countries (Figure 1). In fact, among the more mature economies only Germany, Switzerland and Japan have been unaffected by the otherwise global bout of house price inflation. There are however noteworthy differences across countries. House price growth has been particularly strong over the past decade in the United Kingdom, closely followed by Australia and Sweden.

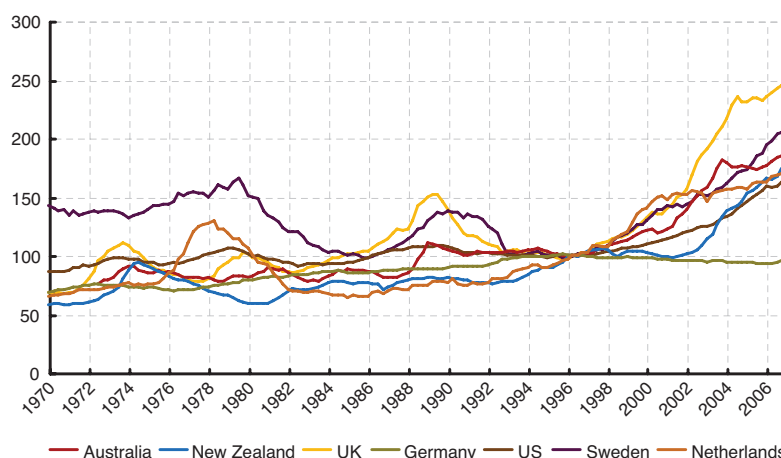
Increases in house prices have been even more noticeable in many central and eastern

European (CEE) economies where house prices increases have been well into the double digit territory for several years. For example, in Latvia, real house prices increased by more than 500 per cent between 2000 and 2006. Interestingly, real house price growth has been more subdued in many Asian economies. In many cases real house prices are still below their levels before the Asian crisis in 1998 (Figure 2 - overleaf).

2.2 Household Indebtedness

Household borrowing has increased considerably in a number of industrialized and emerging economies. Thus, increased household borrowing has gone hand in hand with increasing house prices.

Figure 1 - Real House Prices in Selected Mature Economies (1996 = 100)



Note: Nominal property prices deflated by the consumer price index. Sources: BIS and Reuters EcoWin

* The views in this paper are solely the responsibility of the authors, and do not necessarily reflect the views of their respective institutions.

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Regardless of large differences between countries, the bulk of household debt is related to housing finance or mortgage borrowing, which in many cases has increased as a share of total debt. This growth is reflected both in size of mortgage debt relative to GDP and per capita, as well as mortgage debt relative to household income.

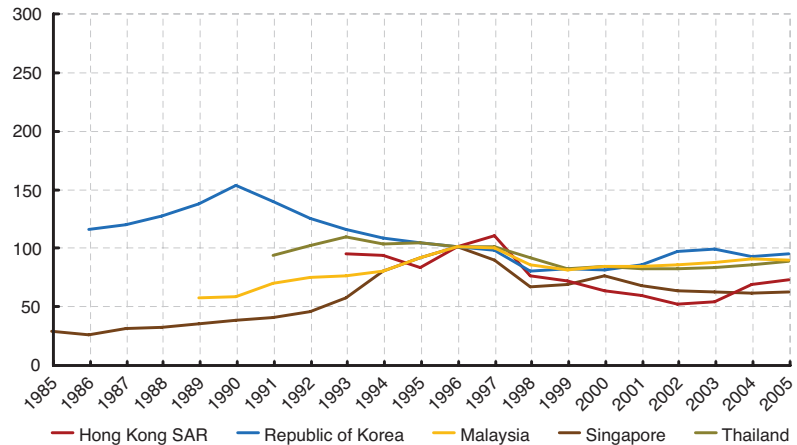
Regardless of the growing weight of housing finance, the size of mortgage markets differs between countries, with debt levels varying in mature markets from 130 percent of GDP in Switzerland to just above 10 per cent in Italy (Figure 3). The differences in indebtedness between countries are to some extent due to differences in the owner occupancy rates, but differences in national housing finance markets also play an important role (see section 3.3).

Even though housing debt has grown, the decline in interest rates globally has meant that debt service costs have not risen as much as debt, and in a number of countries the debt service cost have even declined (CGFS (2006)). In addition, household assets have also increased, implying that the net debt level has not increased nearly as much as gross debt levels. Even in countries where the accumulation of household debt has been particularly strong, the debt to asset ratios have increased only slightly, and in most countries the debt-to-asset ratio has been quite stable (CGFS (2006) and OECD (2007)). In addition, in most countries average household net wealth has been growing faster than disposable income over the most recent years. The increase in net wealth reflects increases in the financial holdings of households, as well as rising house prices.

3. Drivers Behind the Recent Developments
3.1 Macroeconomic Factors

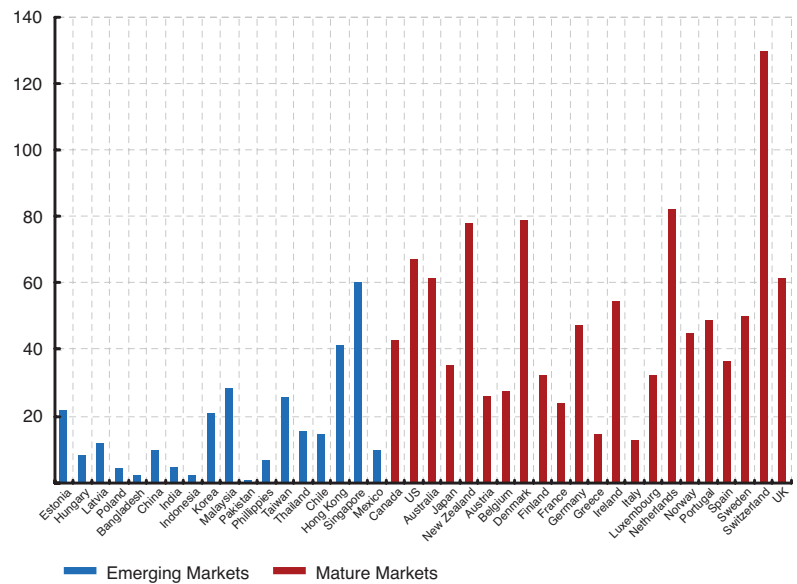
Irrespective of opinions on the level of house prices, there are a number of common factors that have influenced house price developments and the increased indebtedness of households. Since the mid-1990s, interest rates and inflation volatility have dropped sharply. Lower interest rates imply lower financing costs for households. To the extent that lower interest rates are perceived to be permanent, households thus can afford to borrow more, which tends to push up house prices. In many

Figure 2 - Real House Prices in Emerging Asia (1996 = 100)



Note: Nominal property prices divided by the personal consumption deflator or consumer price inflation.
Sources: National data

Figure 3 - Mortgage Debt to GDP in Emerging and Mature Markets (per cent)



Note: Measured as an average for the period 2001-2005.
Source: Warnock and Warnock (2007)

countries, the rise in house prices and build-up of household debt have gone hand in hand. Rising disposable incomes in the household sector and faster economic growth and lower output volatility in many countries have fuelled house price increases because households can afford to pay more for their homes. Higher incomes in combination with lower interest

rates have also meant that more households have gained access to the credit market, thereby helping to boost demand for houses and loans. Demographic factors may also have influenced house price developments. In the United Kingdom and Denmark, there are signs that the proportion of first-time buyers, in relation to the total population, may have a

positive impact on house prices. When a large number of first-time buyers enter the housing market the demand for houses should increase, leading to a rise in prices.

In Asia, as well as in Europe, strong economic growth and rising household income have also been important drivers of the demand for housing finance. In Asia, an additional factor, particularly in lower-income economies, has been rapid urbanisation. The percentage of urban population in most emerging Asian economies has increased considerably throughout the 1990s, a trend which is expected to continue, suggesting that the demand for private housing and housing finance will remain strong in the coming decades in these economies.

Furthermore, in virtually all countries, the technological and legal/technical improvements have been noticeable in housing finance markets. Improvements in information technology - advances in computer programs, databases and statistical computation methods - coupled with financial innovations, have created higher efficiency. In combination with increased competition, this has helped to squeeze credit institutions' margins, thus lowering mortgage rates. Technological improvements also have enabled better pricing of risk and return on the underlying collateral and meant that it is easier for borrowers and lenders to obtain information about each other. In addition, to some extent, mortgage institutions have increased their loan-to-value ratios. Also, households today can choose between a larger range of mortgage contracts with different terms and conditions. Variable-rate contracts recently have stood out as an attractive option. In some countries there is also a growing interest in loans with interest-only payments over a number of years, or even loans that have an initially negative amortization plan. When the total mortgage cost comprises interest payments only there is a greater opportunity to borrow larger amounts.

3.2 Deregulation and Financial Liberalisation

Deregulation and financial liberalisation have made changes in housing finance markets possible in several countries over the past two decades. Many official barriers and credit restrictions have been relaxed or removed as

governments have reconsidered the legal and regulatory framework in which financial institutions operate. In the past, regulations in the financial services industry, especially as applied to banking organizations, tended in many countries to focus almost entirely on safety (eg consumer protection and prevention of failures). However, over time, the focus of regulatory frameworks has shifted from regulatory control towards enhancing efficiency through market discipline, supervision and risk-based capital guidelines. It is difficult to disentangle the effects of regulatory reform in financial services from the effects of advances in technology and innovations in financial engineering that work in the same direction and may precede regulatory changes. This is particularly true in situations where deregulation in the financial service industry is a response by policymakers to technological advances, and when regulatory changes have simply reflected changes previously implemented by market participants.

3.3 Mortgage Contracts

Many economies, developed as well as emerging, have seen a broadening of the menu of available contract types. Most notably, countries that have historically relied predominantly on fixed rate mortgages have seen a growth in the use of variable rate type mortgages. In addition to the increased product choice, many housing finance markets have had a trend towards higher LTV ratios, partly reflecting changing market practice and regulatory changes, resulting in lower down payments for housing loans. Today, most markets have contracts with a loan-to-value (LTV) ratio of 80-100%, although in some cases this may be restricted to 60% (Germany) and can reach 125% (Netherlands).

Despite these common trends in the mortgage markets there are still significant differences across markets when it comes to the loan or contract types typically used. Indeed, some markets still rely almost exclusively on adjustable rate loans and others predominantly on fixed rate loans (CGFS 2006). Pre-payment conditions and rights (options) is another area where there are large differences across markets. For instance, in the US market the standard fixed-rate loan includes an option or right to prepay without compensating the

lender for capital or market value losses. By contrast, in Germany the lender can ask for compensation of foregone earnings. In other European countries, it is standard to include some type of prepayment fee in the mortgage contract to reduce borrowers' incentive to prepay, although many European countries have legal limits on prepayment fees. The ability to make home equity withdrawals, that is, allowing the borrowers access to increase the level of debt by borrowing against "unused" collateral, is also an area where there are significant differences across markets. It is perhaps worth noting, that home equity extraction during downturns in the United States, the United Kingdom and Australia, are considered to have been a major source of support for household expenditure (Reserve Bank of Australia, 2003).

3.4 Sub-prime Lending

Another noteworthy trend over the past years, mainly in the US, but also in the UK, Australia and Canada, has been the growth of lending to households with impaired or insufficient credit history (ie sub-prime lending). In most cases, sub-prime lenders are specialised credit institutions that are either independent or a subsidiary of a larger commercial bank, finance company or investment bank. In the US market, sub-prime lending accounted for roughly 16 percent of the total stock of loans 2006. Furthermore, sub-prime lending had posted a much faster rate of growth than prime lending. Following a run of policy rate hikes in the US, many households with sub-prime loans faced difficulties in repaying their loans in early 2007, and eventually a number of leading institutions that had specialised in sub-prime went bankrupt. The problems have now propagated to other markets and hence represent a threat to the stability of the financial system. Thus, these events show a clear need for central banks and supervisors to continuously follow developments in the mortgage market.

3.5 Funding Sources for Lenders

Although deposits have historically been the dominant source of funding, capital market funding or securitisation is becoming increasingly important. However, despite these developments, there are still significant

differences across markets with respect to funding patterns. For instance, the US market is more reliant on securitisation than the European and other markets. This is illustrated by the fact that the estimated outstanding amount of mortgage backed bonds in Europe is around one-fifth of that in the US.

In many of the markets, the growth in housing finance debt levels have occurred simultaneously with signs of increased interest in, and demand for, capital market funding. The typical pattern is that capital market funding is used when the deposit base no longer is sufficient to fund the demand for credit, or when banks no longer wish to hold housing finance loan exposure. At present, it is possible to distinguish between two distinct approaches to the development of liquid secondary mortgage-bond markets. One is a US-style approach, built around a system with a dominant, standard-setting (possibly government guaranteed) bond issuer. The second approach is based on a gradual market-participant led effort, only aided by the introduction of necessary legislation needed for securitisation to take place.

The first approach, although in different forms, is being followed in Mexico, Japan, Korea and other countries in Asia. Here, government supported housing finance agencies have in part been established with the purpose of establishing a liquid secondary mortgage bond market (Chan et al (2006, 2007)). In Europe, the dominant pattern is still limited or no use of securitisation for funding (EMF (2007)). There are however a number of countries, including Denmark, The Czech Republic, Hungary, Sweden and Spain, where a significant part of residential mortgages have been funded via mortgage bonds. In addition, several European countries have implemented, or are implementing, laws to facilitate issuance of mortgage bonds or covered bonds.

4. Household Debt, Credit Risk and Financial Stability

The development patterns seen in recent years in household indebtedness, particularly those linked to housing finance, have raised concerns about housing finance related credit risk and the stability of the financial system. In this part of the paper we present some of the

work done by central banks focused on assessing the potential risks emanating from housing finance markets.

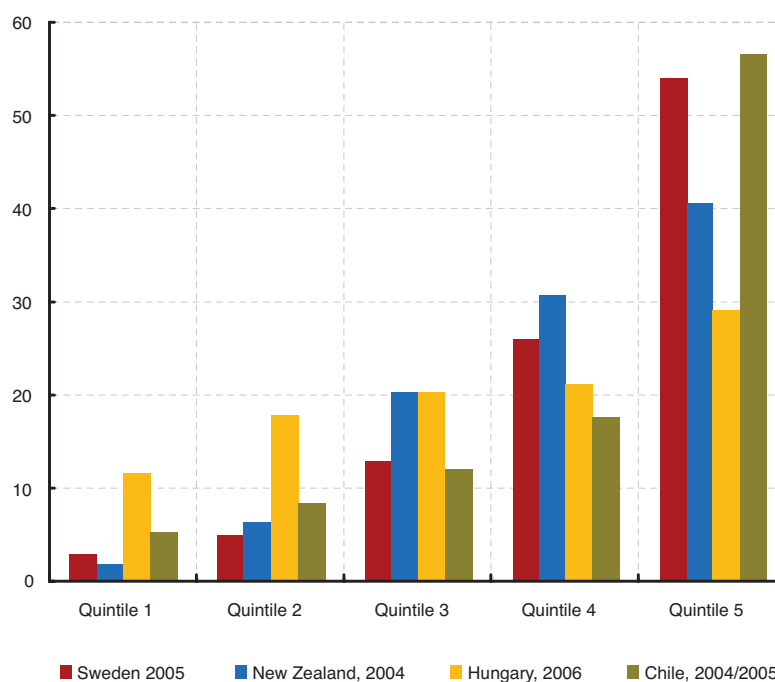
It is an open question how one should monitor and assess financial stability risks emanating from housing finance markets. One common focus area has, however, been to collect data that allows for a more granular or differentiated analysis of household indebtedness. This reflects that evaluating potential financial stability risks emanating from housing finance markets is difficult if one relies exclusively on aggregate data from the financial- and national accounts as such data does not provide information regarding the distribution and matching of debt and interest rate expenditures and income. From a financial stability perspective, this suggests that data providing more detailed information regarding individual households (so-called micro-level data), may help unmask pockets of vulnerabilities in the household sector.

Below we present three types of micro data from selected countries that has been collected with the view to assess the debt bearing capacity of the household sector, and thus the financial stability risk emanating from the household sector; 1) the distribution of debt across income groups, 2) debt service ratios and 3) the financial margin of households.

4.1 Distribution of Debt and Income

One rough measure of the risks in household lending is the distribution of household debts across income categories. It can be argued that the lower the share of debts held by the lower income echelons, the lower are the risks associated with household lending. Clearly, if the lower income groups hold a very small share of total household debt, this could indicate the presence of binding credit constraints which, in general, impose welfare costs on society. Hence, a heavily skewed debt distribution (towards high income

Figure 4 - Share of Debt Held by Different Income Quintiles (percent)



Note: The results should first and foremost be seen as indicative, since differences in definitions make exact comparisons difficult.

Sources: The Reserve Bank of New Zealand (2006), the Riksbank, Statistics Sweden, The National Bank of Hungary (2007) and the Central Bank of Chile (2006).

earners) is not a necessarily a benign feature of the economy.

As can be clearly seen from Figure 4, which plots the distribution of debts across five income quintiles for four countries, the higher income echelons hold the largest share of the household debt in all the surveyed countries.

4.2 Debt Service Ratios

Another way to measure the vulnerability of an indebted household is to calculate the share of income that the household devotes to debt service. A high ratio would indicate that a household is relatively sensitive to swings in interest rates and income. Figure 5 shows the median share of income that is devoted to interest payments (the interest ratio) for the five income quintiles in Sweden and New Zealand.

The differences between the two countries are striking. First of all, the average interest ratio is smaller in Sweden than in New Zealand. One reason for this is, obviously, that mortgage rates were substantially higher in New Zealand than in Sweden in 2004. More puzzlingly, however, are the different slopes of the two lines - the interest

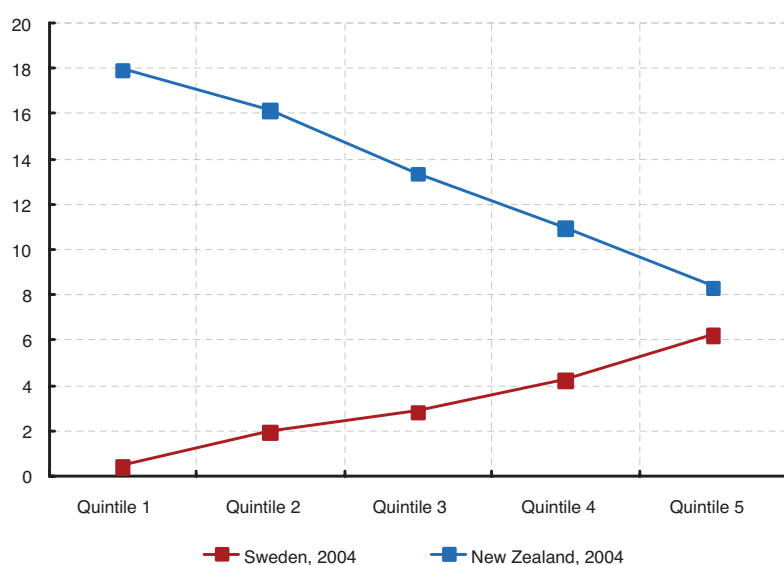
ratio rises with income in Sweden, while the opposite happens in New Zealand. Since households in the highest income quintiles in Sweden and New Zealand devote roughly the same share of their income to interest rate expenditures, this suggests that the wealthier households in Sweden and New Zealand are equally well equipped to handle rising interest rates, while economically weaker households are more at risk in New Zealand than in Sweden.

4.3 The Financial Margin

A different “ability to pay” measure, which is increasingly being used by central banks, is the absolute buffer or financial margin available to the household after it has serviced its debt and paid for its living costs, where proper attention is paid to the household’s size and composition. A household with a margin less than zero would find it hard to make ends meet, and therefore might default on its debts. In what follows we will use the work by the Swedish Riksbank as an example (for details, see Johansson and Persson (2006)), but note that other central banks (eg The Hungarian National Bank and Polish National Bank) also employ this approach.

In Sweden in 2005, just above 7 per cent of the households registered a margin less than zero (henceforth vulnerable households), and were hence likely to find it hard to service their debt. However, as the ultimate goal is to monitor potential credit losses in the banking sector, it does not suffice to just calculate the proportion of households that lie below margin, without taking into account their share of the total debt of the household sector, and the value of the assets that can be used to cover losses incurred by a default. If a large proportion of the household sectors lacks economic margins, but at the same time, hold very little debt, this means that the aggregate risks associated with household lending still is small. In Sweden, it was found that vulnerable households together held about 5 per cent of the total debt in the household sector. Finally, to gauge the potential credit losses that would be incurred on the banks were the vulnerable households to default, one can calculate the net worth, ie assets minus liabilities, of the vulnerable households. If the net worth of a household is larger than zero it does not matter if the household defaults or not, since the credit loss still would be zero. The Riksbank found that even if the vulnerable households were to default on their debts, a majority of debts would be covered by collateral and hence credit losses would remain very limited.

Figure 5 - Interest-to-Disposable Income for Different Income Quintiles (percent)



Note: The results should first and foremost be seen as indicative, since differences in definitions make exact comparisons difficult.

Sources: The Reserve Bank of New Zealand (2006), the Riksbank and Statistics Sweden.

One of the main benefits of working with an absolute financial margin is that it offers a transparent framework that can be used to stress test the household sector. The Riksbank continuously performs stress tests to investigate the effects on potential credit losses for a variety of adverse macroeconomic scenarios. In general, the Riksbank found that in Sweden credit losses from household lending can be expected to be low, even in the face of an adverse macroeconomic development. Moreover, credit losses are found to be more responsive to changes in interest rates than unemployment. One explanation for this is the composition of the households' debt and income. Household debt is, by and large, concentrated to the highest income category. These households often consist of two employed adults, and hence the household has dual incomes. Thus, even if one individual in the household becomes unemployed, the other individual's income, together with the unemployment benefit, is usually enough to cover living costs and interest rate expenditures.

5. Concluding Thoughts

Many countries have benefited from the growth in housing finance markets in recent years. Risk-based pricing of loans based on credit scoring have in many cases resulted in more efficient allocation of loans. Increased use of securitisation has allowed investors to diversify into a new asset class in markets which they previously did not have access to. The analysis conducted by central banks and others suggests that in many countries the level of indebtedness is broadly affordable. In addition, in most cases the majority of borrowers appear to be able to absorb both declines in house prices as well as higher interest rates.

Nevertheless, it has not gone unnoticed that the significant growth of household borrowing and higher house prices have coincided with a period of low interest rates and improved access to credit. It is also clear that over the same period new, more complex, types of mortgage contracts have been introduced.

To gauge the potential financial stability of these developments central banks face several difficult questions. One important question or concern is that increased use of adjustable rate mortgage loans and other new mortgage instruments increases households' sensitivity to changes in mortgage interest rates. A related concern is that not all households may fully understand their mortgage contracts, or how their payments could change in reaction to interest rate shocks or other developments. A related question is if investors have the capacity to evaluate credit risks related to new housing finance borrowers.

A second set of questions concern the capacity of banks and other financial institutions to meet the increased need for careful management of credit, operational and reputation risks linked to housing finance markets. The relevance of these concerns has been re-emphasised by the recent financial market turmoil which was clearly linked to concerns and uncertainty regarding the size and distribution of credit losses in the US sub-prime housing finance market. These events show that a combination of low interest rates, sophisticated mortgage products, as well as increased lending to households with lower credit worthiness may be more risky than initially expected.

To gauge financial stability risks, central banks and private investors are already conducting more detailed analysis of housing finance markets using micro data. To continue and improve these efforts, central banks as well as housing finance market participants need to ensure, possibly via collaborative efforts, that they have access to a broad array of disaggregated data, particularly for more vulnerable subgroups of households. Furthermore, policymakers need to ensure access to high quality house price data. Central banks have also conducted stress tests focussed on housing finance markets, and are also encouraging market participants to engage in similar types of stress testing. Up to now, these tests have focussed on household financial vulnerability and house price developments. Increased reliance on market funding as well as the recent market turmoil suggests however, that going forward it might be useful to ensure that stress tests should also focus on liquidity risks.

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Managing Mortgage Arrears and Possessions in the UK

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Introduction

This article presents the findings of a survey of lenders in the UK commissioned by the Council of Mortgage Lenders and carried out by the Centre for Housing Policy. The survey provides a detailed profile of home-owner arrears and possessions, and lenders' policies and procedures towards them.

The previous review of lenders' role in the arrears and possessions process (Ford et al, 1995) was completed more than a decade ago at the end of a housing market recession marked by record arrears and possessions, falls in nominal house prices and extensive negative equity (see chart 1).

The arrears and possession situation today is materially different from the early-mid 1990s, although there has been some evidence of deterioration since 2004.

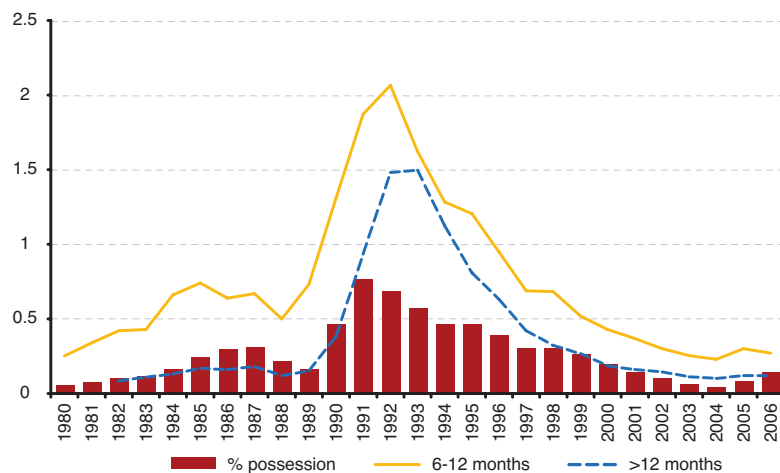
A review of lenders' management of arrears therefore appears timely. Much else has changed since the early 1990s which means that lenders are now managing arrears in a very different context, as detailed below. The remainder of the article presents the key findings of the research on arrears and possessions and their management.

Background

Safety Nets

One of the key changes since 1995 has been the changes in the safety net for borrowers. From October 1995, a waiting time of nine months (with a few exemptions) before borrowers with new mortgages became eligible for Income Support for Mortgage Interest (ISMI)

Chart 1 - Arrears and Possessions 1980-2006



Source: Council of Mortgage Lenders

was introduced. The Government hoped that more borrowers would take out Mortgage Payment Protection Insurance (MPPI) to cover the gap. While MPPI coverage grew to 24% of mortgages in 2003, it has since declined to below 20% in the second half of 2006. Meanwhile ISMI claims have fallen from 529,000 claimants in 1994 (and a peak of 555,000 the previous year) to 236,000 in 2005 - primarily reflecting improvements in the labour market (Wilcox, 2007).

A recent report found that 90% of borrowers have a short-term safety-net in the form of savings, flexible mortgage resources or employee benefit. However, 40% have no medium-term cover in the form of insurance. Only 12% have short, medium, and long-term cover (Ford et al. 2005).

A degree of uncertainty surrounds the way in which the current safety net would behave during a recession, although Ford and Wilcox (2005) calculate that there would have been a net increase of 80,000 (23%) mortgages in arrears had the post-1995 safety net regime been in force in 1992.

Industry and Regulatory Changes

The mortgage industry has also undergone significant structural changes over the past decade. A wave of building society demutualisations took place in the mid-1990s with the consequence that banking organisations are now the dominant players in the market (Stephens, 2001; 2007). Consolidation has continued, although there have also been a number of new entrants, mostly operating on the specialist lender model

* This article was first published in CML Housing Finance, Issue 5, 2007. It is published here with the kind permission of the Council of Mortgage Lenders.

- that is without a branch network and raising funds from a parental institution or on the wholesale markets, often through securitisation.

The changes in the industry have been reflected in the abandonment of the regulatory divide between the Building Societies Commission and the Bank of England, with each of their regulatory functions being assumed by the Financial Services Authority. The CML introduced a voluntary Mortgage Code in 1997 for lenders (and from 1998 for intermediaries) until it was superseded by statutory regulation of new residential mortgages from October 2004.

The Housing and Mortgage Market

The housing market has undergone substantial strengthening since 1994, with a prolonged period of house price rises amid an environment of historically low nominal interest rates (chart 2). The bottom of the interest cycle has now passed and interest rates have been rising, while staying well below the levels experienced in the first half of the 1990s (chart 3).

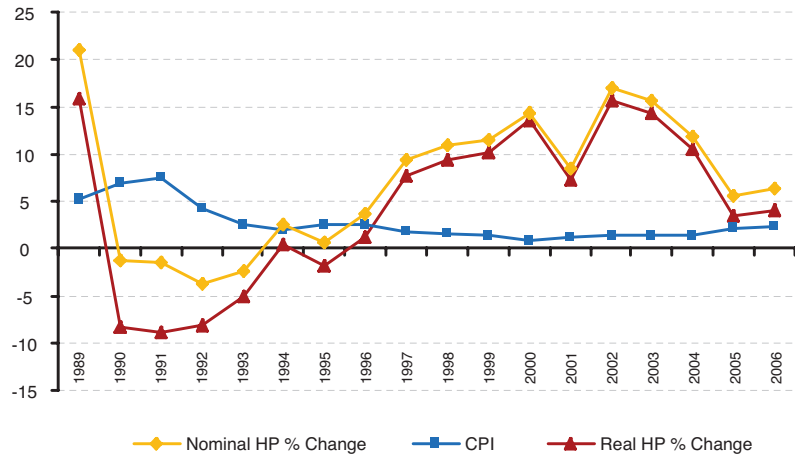
In 2000, the phasing out of Mortgage Interest Relief at Source (MIRAS) was completed, for all but residual numbers of elderly home income plan holders.

By the end of 2005 there were more than 11.5 million mortgages outstanding. While this represented a rise of more than 10% since 1994, the rate of growth had declined markedly compared to the previous decade (when the comparable increase was more than 40%).

First-time buyer numbers have declined. Having made up 55% of all new loans in 1993 and 1994 (the peak years), they accounted for only 36% in 2006 (CML). Typical loan-to-value ratios have edged down (from 95 to 90%) but income multiples have risen strongly (from 2.3 in 1994 to 3.2 in 2006).

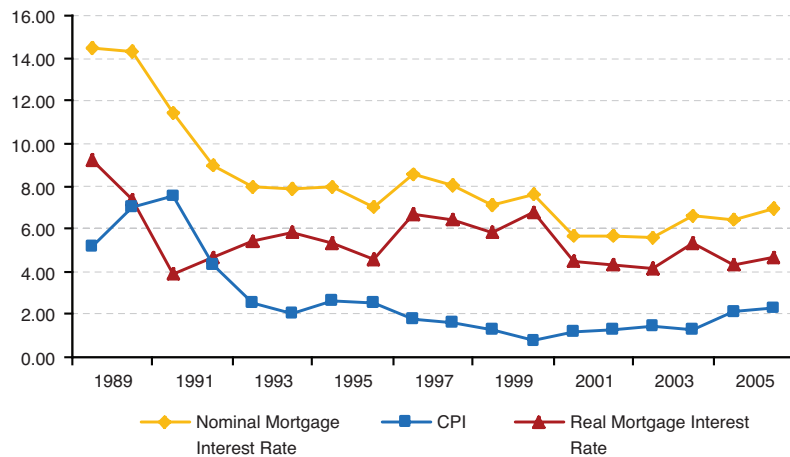
The past decade has seen both a marked shift away from endowment-linked mortgages towards capital repayment mortgages and, over the past few years, stronger take-up of interest only mortgages without a specified repayment vehicle. Recently, these have accounted for as much as a quarter of new lending for house purchase (CML).

Chart 2 - House Price Inflation 1989-2006



Source: Communities and Local Government (House Price index); National Statistics (CPI)

Chart 3 - Annual Interest Rates



Source: Communities and Local Government (mortgage rates); National Statistics (CPI)

The period has also seen shifts in demand for different mortgage types. Flexible mortgages, with features such as over- and under-payments and payment holidays, became more available from the mid-1990s, and appear to be taken up by slightly better off, slightly older and somewhat more risk averse borrowers than the average (Smith et al, 2002). There has also been a decline in the popularity of standard variable rate mortgages since the 1990s, with two-thirds of new mortgages and remortgages in 2006 at fixed

interest rates, although the demand for these has varied greatly over the cycle.

An important new market has been the emergence of the 'non-prime' sector, which has extended lending to groups who might otherwise have experienced difficulty in accessing mortgage finance (Munro et al, 2005; Pannell, 2006). There is no industry agreed definition of non-prime, but for the purposes of this paper we regard it as including both impaired credit mortgages, where the

borrower has some history of default, and self-certificated mortgages, where the borrower does not verify income (for example, because they are self-employed or their earnings are erratic). This definition may also differ from that used in other jurisdictions.

Growth in Consumer Debt

There has been an unprecedented growth in personal indebtedness, both secured and unsecured, over the past decade, and inevitably greater repayment difficulties

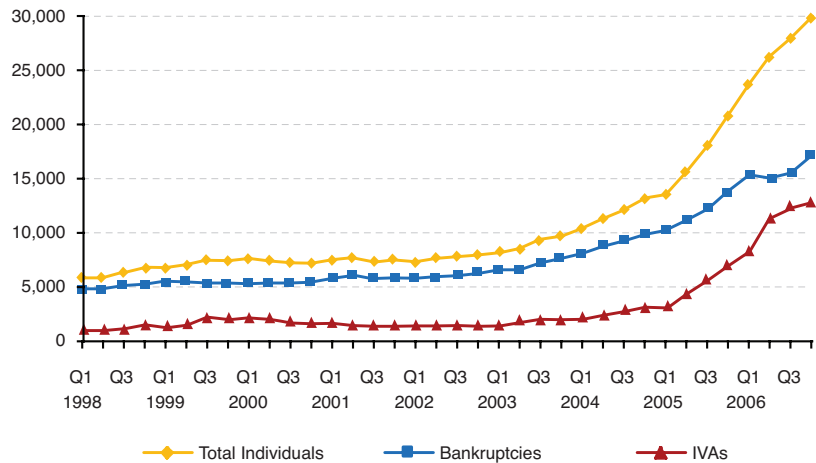
In recent years there has been a significant rise in individual insolvency, in the form of bankruptcies and Individual Voluntary Arrangements (IVAs), an alternative to bankruptcy whereby the debtor reaches an arrangement with creditors), and their equivalents in Scotland) (chart 4).

Growing numbers of charging orders, by which unsecured creditors secure the repayment of the debt from the proceeds of sale of the property, also illustrates the increasing financial stress that some households are facing.

The Research

During 2006, a questionnaire was sent to all CML members, asking lenders to provide detailed information on arrears and possessions and their approaches to their

Chart 4 - Number of Individual Insolvencies in England and Wales (seasonally adjusted)



Source: Insolvency Service

management. Data related principally to 2005. Since the default landscape changes rapidly, the percentages reported here may have changed since 2005.

Forty three lenders returned the questionnaire, between them managing nine million mortgages representing more than three-quarters of the industry total. Banks and building societies respectively accounted for 76% and 22% of the mortgages managed by survey participants. Specialist lenders managed a little over 2% of the total but accounted for 8% of new mortgages.

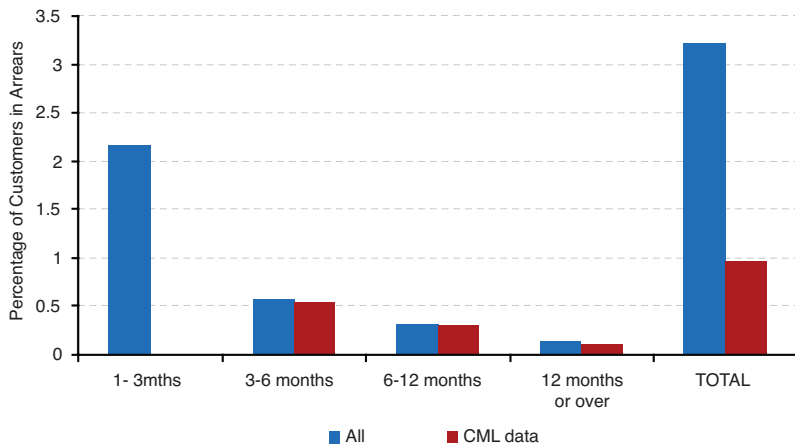
Just under 10% of mortgage assets were classified as 'non prime', defined by the research team as sub-prime and self-certified lending. This definition may differ from that adopted by different lenders and that used in other jurisdictions. The predominant business of the specialist lenders was non prime, building societies were relatively lightweight in this regard and the banks had a share broadly in line with their overall market share.

Levels of Arrears

The lenders in our survey reported that 3.2% of their borrowers were in arrears at the end of 2005 (chart 5). The arrears were heavily concentrated in the very short-term category of 1-3 months, which accounted for more than two-thirds of all arrears cases. In contrast 0.6% of mortgages were in arrears of 3-6 months; 0.3% of 6-12 months and only 0.1% for more than a year. These figures are similar to those published by CML for mortgages more than three months in arrears.

As one would expect, the incidence of arrears was higher among non-prime mortgages (see chart 6). Overall, 11.3 % of non-prime mortgages were in arrears, compared to 2.9 % of prime mortgages. The differential between the proportion of non-prime and prime mortgages in arrears was greatest for short-term arrears and smallest for arrears of more than 12 months. The data is consistent with the

Chart 5 - Level of Mortgage Arrears (Survey and CML Data)



Source: CML survey of arrears management

Notes: Base: 41 lenders (25 building societies; 13 banks; 3 specialist lenders)

view that earlier action in the case of non-prime arrears results in speedier resolution or possession than among prime mortgages.

Management of Arrears

It is rare for lenders to fully outsource arrears management functions. Most firms (71%) manage arrears entirely in-house, with a further 24% using a combination of in-house staff and external staff.

The vast majority of lenders (eight in ten) reported that statutory regulation had made little or no difference to their management of arrears cases, but had prompted changes in notification. In the few cases where firms reported that statutory regulation had led to significant changes, these included staff obtaining the CeMAP qualification¹, more quality assurance checks on staff, the introduction of quarterly arrears statements and telephone call recording.

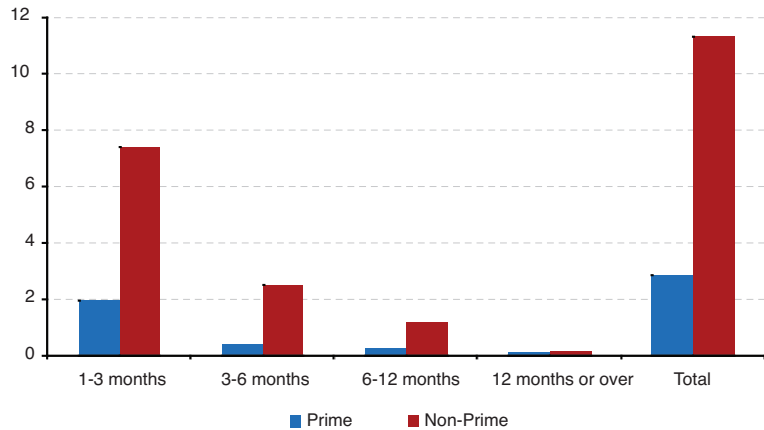
The vast majority of lenders place a high importance on making early contact with borrowers. Almost all lenders (90%, covering almost 80% of borrowers) aimed to make first contact after one full or part payment had been missed.

Moreover, 81% of lenders, representing three-quarters of borrowers, exceeded the statutory requirement by providing information to all their customers in a durable medium within 15 business days of two missed payments, not just those with regulated mortgages.

All respondents identified the resumption of normal payments plus a contribution towards the arrears as being a strategy employed in the prime sector to recover arrears, with slightly fewer employing a strategy of full interest payments combined with a contribution towards arrears (chart 7). A similar pattern is seen among loans in the non-prime sector, although fewer lenders appear to employ particular recovery strategies.

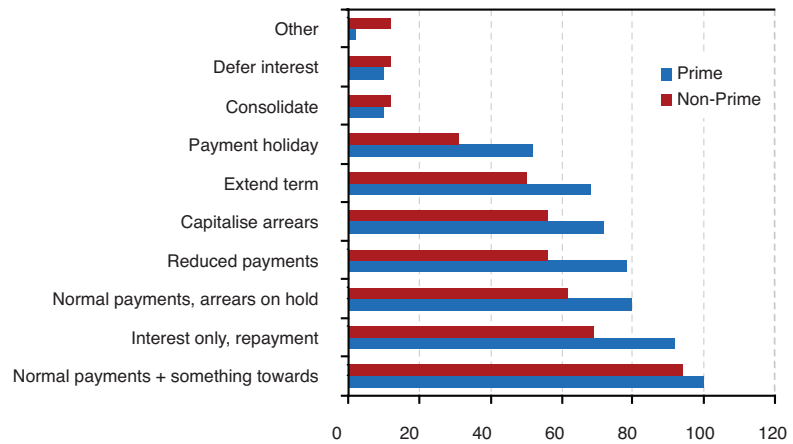
Within the prime sector, only 20% of borrowers with arrears had a payment agreement in place. This seems to be a relatively low figure, although past research suggests that during

Chart 6 - Level of Mortgage Arrears (% of Mortgages in Arrears)
Prime and Non-Prime Sectors



Source: CML survey of arrears management.
Base: Prime Sector: 37 Lenders; Non-Prime Sector: 12 Lenders

Chart 7 - Strategies Used to Assist Borrowers with Arrears
(% Lenders Using Specified Strategies)



Source: CML Survey of arrears management.
Notes: Base: Prime sector: 40 Lenders (25 building societies; 13 banks; 2 specialist lenders); Non-prime sector: 16 Lenders (7 building societies; 5 banks; 4 specialist lenders).

the last housing recession lenders improved the incidence of contacts and agreements from a relatively low base (Ford et al, 1995).

Some of this may reflect the fact that two-thirds of arrears cases were less than three months down and an agreement may not yet have been put into place. If we examine mortgages that are three or more months in arrears, a slightly higher proportion (23%) had an

agreement in place, with a further 6% having had an agreement which had subsequently broken or lapsed. However, the majority (71%) had no agreement in place yet.

The survey also suggested that once an outright possession order had been obtained, agreements were rare.

¹ The Certificate for Mortgage Advice and Practice (CeMAP) is a professional qualification offered by the Institute of Financial Services and is a prerequisite for becoming a mortgage adviser.

More than 80 % of arrangements fell into three categories. The most common arrangement was the combination of normal payments with payments towards arrears (42%); while reduced monthly payments (22%) and temporary payment holidays (20%) were also important. While figures are not strictly comparable with Ford et al (1995), a similar pattern was observed in the early 1990s with monthly payments plus something towards arrears being the most frequently used type of payment arrangement, closely followed by reduced payments and normal payments - the key difference over time is the substantial increase in the use of temporary payment holidays.

The survey did not provide us with sufficient data to examine the different use of payment arrangements within the non-prime sector.

The nature and level of services to borrowers in arrears varies between lenders. Both lender and Financial Services Authority advice suggests that borrowers experiencing payment difficulties should contact lenders as soon as possible. In this respect, some 60% of lenders provided a named contact, 45% an evening phone line and 21% a free-phone helpline. More than 80 % (81%) of lenders provided information about independent advice services. Some 60 % of lenders provided debt counselling and around half provided daytime branch interviews and home visits. Almost half (49%) of lenders always charged for home visits and more than 60 % always (39%) or sometimes (21%) charged for letters. It was rare for charges to be made for outward bound phone calls and no lender reported charging for branch interviews.

Lenders clearly attach importance to a borrower's eligibility for the state social security (ISMI) and private insurance (MPPI) safety nets (table 1).²

Eight in ten lenders stated that coverage of all interest payments by ISMI always or usually made a difference in making arrears decisions; in the case of MPPI the impact was almost universal (98%). When part of the interest payment is met, these figures dropped

to 46% for ISMI and 56 % for MPPI. The prospect of qualification would always or usually make a difference in 70 % of cases for MPPI, but never 'always' and only 41% 'sometimes' in ISMI cases.

It is not clear why lenders' attitudes to safety net payments should differ according to their source - apparently preferring MPPI to ISMI. Nor is it clear why the same resource (MPPI or ISMI) should prompt such different responses from lenders. The findings of the present study are consistent with earlier evidence that suggested that lenders may be less willing to forbear during the ISMI wait period than MPPI deferral period and are less sympathetic when shortfalls are present (Ford and Quilgars,

2001). They may in part also reflect the capped nature of ISMI payments.

Of the other factors that lenders identified, whether this was the borrower's first time in arrears and the existence of health problems emerged as the most significant. The existence of a charging order was the least likely of the factors suggested to make a difference.

**Table 1 - Factors That Are Important in Making Arrears Decisions
(% of lenders stating that the factor made a difference)**

	Always	Usually	Sometimes	Rarely	Never
<i>Formal Safety Nets (ISMI and MPPI)</i>					
ISMI covers part of interest	13	33	44	10	-
ISMI covers all of interest	41	39	15	5	-
Qualify for ISMI in future	-	41	18	28	13
MPPI covers part of payment	18	38	40	5	-
MPPI covers all payment	56	42	2	-	-
Has MPPI; may qualify in future	10	60	23	5	3
<i>Borrower's Resources</i>					
Considerable equity	7	42	29	17	5
First time in arrears	15	49	22	10	5
Multiple debts	22	32	22	17	7
Charging order related to another loan on property	5	18	33	18	28
<i>Social Factors</i>					
Health problems or disability	22	37	42	-	-
Borrower over state retirement age	15	32	44	-	-

Source: CML survey of arrears management Notes: Base: 42 lenders

² Income Support for Mortgage Interest (ISMI) is a means-tested social security benefit that assists home-owners with their mortgage interest payments. Since 1995 people with a new mortgage have had to wait nine months before they start receiving assistance, the idea being that they should make provision for short-term income loss through savings or private insurance. Mortgage Payment Protection Insurance (MPPI) describes voluntary private insurance taken out by borrowers to meet their mortgage payments in the event of income loss arising from a defined event such as accident, sickness or unemployment. Around 20 per cent of borrowers have some form of private mortgage insurance..

Litigation and Possession

Possession is only one possible outcome of arrears and possession actions by lenders and the courts. The Ministry of Justice figures show that mortgage possession proceedings in the county courts in England and Wales strongly outweigh CML estimates of actual possessions. In 2006, 131,681 claims and 91,195 orders were made by the courts, representing an increase of 14 % and 30 % on 2005 figures, respectively (MoJ 2007).

The survey identified more than three-quarters of lenders (78%) as having formal criteria in place for initiating court action. These tended to be designed around two key aspects of arrears: first, many lenders had a time criterion (most commonly three months, but also two, four and in one case six months); second, many lenders also coupled this with a criterion that no contact had been established with the borrower, all other remedies had been exhausted and/or occasionally debt counselling was unsuccessful.

Among those lenders that were able to provide data for 2004 and 2005, there was a 29% increase in the number of applications made for a first court hearing. These appear to have been concentrated in the non-prime sector.

Table 2 - Outcomes of Court Cases at First Judgement, 2005

	Prime	Non-prime	All
Granted outright possession order	36%	41%	40%
Granted suspended possession order	52%	55%	53%
Adjourned	11%	4%	6%
Dismissed	0.2%	0.4%	0.2%
All	100%	100%	100%

Source:

Notes: Base: 21 lenders providing all figures

(16 prime lenders; 3 non-prime lenders; 2 missing on breakdown)

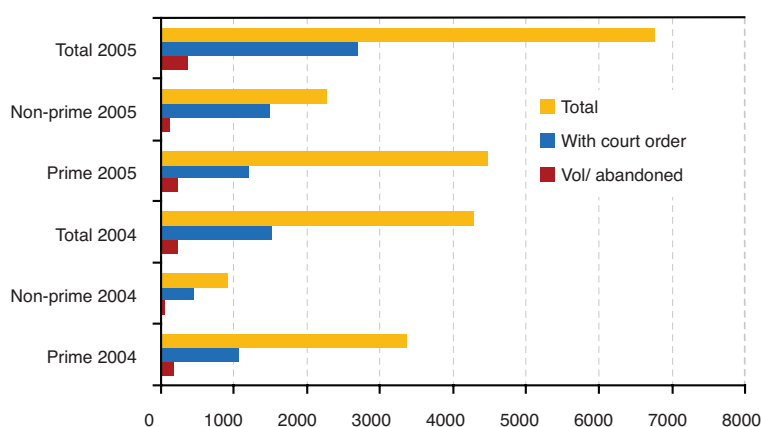
Table 2 indicates the outcomes of first judgements. A suspended possession order was granted in just over half of cases (53%), whereas an outright possession order was granted in 40 % of cases. Most other cases were adjourned; hardly any were dismissed. There were only minor differences in the outcomes for cases involving prime and non-prime loans.

These findings are broadly consistent with the aggregate 2005 figures for England and Wales issued by the Ministry of Justice.

Chart 8 shows the number of possessions in 2004 and 2005 amongst lenders responding to the survey. Our survey indicates that while there was an overall increase in possessions of 58 % in 2005 compared to 2004, this was concentrated in the non-prime sector where possessions rose by more than 150 %.

These results point to a similar proportion of mortgages being taken into possession in 2005 as the grossed-up CML figure (0.08% compared with 0.09%). However, our breakdown between possessions relating to prime and non-prime mortgages reveals considerable differences in the proportion taken into possession: 0.05 % of prime mortgages against 0.51 % of non-prime mortgages.

Chart 8 - Possessions 2004 and 2005, by Prime and Non-Prime Sector



Source:

Notes: Base: 36 lenders (all figures); 29 prime sector; 9 non-prime sector. Matched dataset for 2004 & 2005 (one lender taken out who could not provide 2004 data representing 41 possession cases)

Where lenders were able to provide information about shortfalls relating to properties that had been taken into possession, overall around one-fifth (21%) had a shortfall, but again this varied between cases that arose from prime and non-prime lending (6% compared to 31%). By far the most common method of disposing of a property that had been taken into possession was sale through an estate agent (69%); relatively few (8%) were sold at auction. In 5% of cases, the property was actually returned to the borrower after their arrears had been cleared.

Conclusions

This article has reported the findings of a survey of lenders' arrears and possessions profiles and practices relating to 2005.

The most striking finding is the clear differences between the prime and non-prime sectors of the mortgage market, arising from the differing risk profiles of borrowers. The rate of arrears in the non-prime sector was almost four times greater than in the prime sector. The percentage increase in applications for first court hearings was eleven times greater in the non-prime sector compared to the prime sector. Properties that provided security for non-prime loans were ten times more likely to be taken into possession than were properties providing security for prime loans. Among the properties taken into possession, those relating to non-prime mortgages were on average more than five times more likely to result in a shortfall than those relating to prime mortgages. While the number of lenders providing individual pieces of data varied, there is little reason to suppose that these findings do not reflect of the experience of the industry as a whole.

The research supports the case that the non-prime sector is contributing to the overall deterioration of arrears and possessions (Cunningham, 2007). As outlined in previous articles (Pannell, 2006), no-one can be certain how this sector will perform in a market downturn as it was in its infancy in the early 1990s recession. Whilst providing an important role in providing credit to those who might otherwise be excluded from the mortgage market, it also remains the sector where there is 'likely to be more consumer detriment' (FSA 2006, p. 5). It also needs to be remembered that government targets to increase home ownership will necessitate drawing in more financially marginal households (CLG, 2007) who may disproportionately rely on the non-prime sector.

Taking the data presented here as a whole, their value is to establish existing experiences and practices as we move into a period where the environment will be less benign. Whilst a repeat of the early 1990s housing crisis is unlikely, consumers are now facing a more demanding economic environment with higher

interest rates and growing debt levels (FSA, 2007). If the survey is repeated, they will serve as a baseline from which future policy and practices can develop, in much the same way as the FSA intends to use its effectiveness reviews of the mortgage market.

The survey did not reveal significant impacts arising from the increased use of Individual Voluntary Arrangements, the recent rise in charging orders and reforms to the bankruptcy laws. In part this reflects the lack of recording within lenders and the quality of reporting by the Ministry of Justice. It would be desirable for the necessary information systems to be put in place sooner rather than later.

The article cannot cover the borrowers' perspectives, as the data are based on a survey of lenders. This clearly leaves an important gap in our knowledge and the utility of the data collected in the survey would be enhanced greatly if it were to be filled. Again the next stage of the FSA's review will consider the treatment of borrowers in arrears and this should provide information from which to compose a complete picture of the situation.

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Increasing Affordability Problems - A Role for Shared Equity Products? Experience in Australia and the UK

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What is Shared Equity?

The term shared equity covers a range of financial products that enable the division of the value of the dwelling between more than one legal entity. These products thus enable the main purchaser (often called the primary owner) to reduce their outgoings by giving up rights to part of the equity in their home.

The vast majority of shared equity products are in the form of mortgages - so the purchaser gives up the rights to say 25% of the equity in the dwelling to the mortgage company for the period over which the mortgage is outstanding. In addition the shared mortgage may or may not have an interest rate (or rental element) attached to it.

Other shared equity products involve long term direct ownership of a part of the equity. One example here is the case of properties built on Community Land Trust land where the Trust keeps say 20% of the equity into perpetuity. In these cases the primary owner will never become a full owner of their property, unless the secondary owner decides to sell. In addition there are products where the secondary owner has direct ownership of their proportion of the property but gives the primary purchaser the right to 'staircase' up to 100% when they wish.

These shared equity products may be taken out by first time buyers to reduce the costs of entering the housing market; by more mature owners who wish to diversify their housing equity risks; by older households who are

looking to release equity; or by many other particular groups such as those buying into a golf village where there are strong efficiency reasons for an element of ownership by the management company.

What is clear from these examples is that shared ownership takes many forms and that these enable a range of ways of separating the rights and responsibilities associated with homeownership. In particular it provides a means of varying the primary owner's outgoings in line with their financial situation; of switching between the risks of debt (eg from interest rate rises) and equity financing (ie from variations in house prices); and of transferring some of the risks of house price volatility away from the primary owner. On the other hand the products are inherently more complicated than traditional mortgage and leasehold approaches so that transactions costs are higher; people's understanding of what they have actually taken on may be less; and there are many opportunities for post contractual opportunism on the part of both parties.

Some of the most important issues in assessing particular shared ownership products are how the expenditures and the risks are shared between the primary and secondary owners. The majority of schemes require the primary owner to pay all the repairs and maintenance and other costs associated with ownership. Difficult valuation issues arise when improvements are undertaken which affect the value of the property. Equally the provider of the primary owner's traditional mortgage requires certainty that they can

foreclose on the asset if there are repayment problems. All these aspects generate contractual problems and uncertainties, which can offset some of the potential benefits of lower expenditures and risk transfer.

With respect to risk transfer there are a number of different forms of shared equity contracts. In terms of current outgoings they include those that provide a minimum 'rental' return to the investor involving an interest charge on the proportion owned by the secondary owner as compared to arrangements where all the benefits to the secondary owner lie in capital appreciation. In terms of investment returns, at one extreme there are those where both owners share any variation in house prices in proportion to capital value; those where the secondary owner only benefits from the capital appreciation and takes no downside risk; and those where there is an investor return built in so that the proportion of capital owned by the secondary owner increases over time to provide a, near, guaranteed return on their investment. Obviously these rental and investment elements can be mixed in a variety of ways. Thus shared equity products are very flexible but also very complex.

Rationale for Shared Ownership Products

The main reason why shared equity products are in the forefront of discussion at the present time is that house prices have been rising faster than incomes in the vast majority of industrialised countries. As a result new entrants to the owner-occupied market are finding it increasingly difficult to purchase - and

shared equity can help to reduce initial outgoings and so enable them to purchase. Moreover problems of access and affordability are putting pressure on governments which have a commitment both to meet aspirations for homeownership and an incentive to make any subsidy that they provide to new entrants go as far as possible. Again shared equity products can help meet both objectives.

There are other important reasons why shared equity products are seen as desirable, especially in the economics and finance literature. Moreover these suggest that shared equity products might be suited to a much wider market than simply first time buyers.

The most fundamental is that owner-occupation carries with it very specific risks, which, at least in principle, cannot be efficiently borne by individual households. Portfolio theory suggests that one should spread risks across a wide range of assets with different patterns of returns in the face of changing economic circumstances. Owner-occupation means that most households are investing in a single asset which has a history of significant variation in value and which has the additional complications of being located in a particular location (so that the capital value is affected by local conditions) and having large transactions costs as well as timing difficulties associated with realising the asset. Theory would say that the owner should at least transfer some of the risks involved in owning this specific housing asset to others, notably financial institutions better able to bear the risk. This both provides greater financial flexibility and frees up funds from the housing asset to allow the individual household to invest in other investments with different risk profiles.

Another reason relates to equity release for consumption purposes. Older people in particular will often want to supplement their pensions by running down their investments. For most households their largest asset is their home but many do not want simply to downsize. The alternative is to realise part of the asset either by borrowing against that asset or by selling off part of it - which is where shared equity products of various kinds comes in.

A very different reason relates to the wish by providers to keep some control over the land

and/or the estate by keeping an equity stake in the properties that are being built. This particularly applies in the context of public/private partnerships for the provision of affordable homes. The public sector may want to keep control over who gains access to affordable housing and in particular to ensure that some of the benefits are passed on to future purchasers. This can sometimes best be done by a shared equity arrangement into perpetuity. The same rationale may apply to private providers, especially those building large scale mixed developments where developers are increasingly looking to have a direct equity involvement in the value of the overall asset for both investment and management reasons.

The development of shared ownership products has potential benefits for all relevant stakeholders - including the purchaser; the equity investor; the mortgage and investment industries; and government. For the purchaser it provides a new mortgage class with lower repayments; access to higher valued, larger and better-located property - as well as being sometimes the only way of becoming an owner-occupier. Later on it enables the possibility of equity release; and, throughout the contract period, it can reduce the household's exposure to risks both with respect to interest rates and capital value variations. For the equity investor it enables greater diversification through access to an asset that is not fully correlated with other investments and which is tradable and divisible. However, most of these benefits depend on the development of a secondary market on which the equity from a wide range of dwellings with different specific risks can be packaged and sold. For both the mortgage and investment industries it provides an opportunity to expand into new markets and gives them access to shared appreciation and other derivative products which can reduce the costs of financing. For the government it helps them to lever in private finance and to provide low subsidy and even no subsidy products to households facing cash flow constraints or concerned about housing risk. By expanding owner occupation it also reduces the numbers of households in need in the rented sectors and potentially limits the government's long-term commitments to older households because these households will have an asset that they can realise.

However there are major difficulties associated with the products in terms of higher transactions costs; asymmetric information between the purchaser and provider of the shared equity product; the potential for post contractual difficulties - notably moral hazard in relation to the resale value of the dwelling; the need especially where a secondary market is developed for a price index against which to benchmark payments; the likely thinness of resale markets for products which continue to be partially owned; and many other contractual difficulties. Most importantly there is the question of whether partial ownership undermines the perceived benefits to the owner-occupier who wants to feel they have full ownership and control over their property.

The potential for the development of different types of shared equity products depends on the extent to which these benefits can be realised and offset the costs involved in these more complex products. It also depends on what alternatives are available - for instance in the form of interest only mortgages which reduce outgoings while enabling the purchaser to maintain 100% of the residual value or other forms of equity release. It depends on the legal and administrative system that applies to both the housing and finance markets - in some countries for instance it would require primary legislation to enable partial ownership; in most it requires the development of an appropriate regulatory framework for the financial instruments. Successful expansion of the market also depends on the way shared equity products are handled by the tax and benefit system. Finally it depends upon the government's commitment both to facilitate the growth of shared equity markets and to see the approach as an important set of instruments in their toolkit for ensuring the provision of affordable housing.

Developments in Australia and the UK

Shared equity products exist in a number of countries, particularly those with 'Anglo-Saxon' legal frameworks. Notable is the USA where they are an important part of community development of affordable housing under HOPE VI and other government sponsored schemes. Equally the concept of shared ownership as a means of managing portfolio risk has been developed in the US literature,

notably by Caplin et al in 1997. In other countries, such as France and Germany there are legal constraints on the development of shared equity products. In many others, such as some of the Scandinavian countries or South Korea there is considerable government interest in trying to develop appropriate instruments. However the two countries that lead the world in developing shared equity products are Australia and the UK.

The Early Years

The vast majority of initiatives in both Australia and the UK have been government led. The idea became embedded in policy in the 1970s and 1980s at times when house price inflation was particularly out of line with income growth. The benefits were seen as particularly significant because throughout the period general inflation rates were high and variable. Households therefore faced both strong financial constraints in the early years of the mortgage and significant interest rate risk, particularly as in both countries the normal mortgage instrument was a standard variable rate mortgage. Shared equity products were one way of improving access and longer term affordability as well as reducing risks to the purchaser.

In both countries the original shared equity product, called *shared ownership*, involved provision of dwellings by the public sector and subsidised rents on the equity share owned by government. In the Australian context this was linked to an indexed mortgage; while in the UK purchasers obtained a standard variable rate mortgage and the product was available only for newly built or renovated properties. The purchaser had the right to staircase up in tranches to 100% whenever they wished to do so at a price based on the then current value.

This model worked well in periods when incomes were growing steadily and house prices continued to rise. However there were significant problems especially in Australia during the recession of the late 1980s and early 1990s. These affected both purchasers and suppliers so that it is only since the turn of the century that interest has risen again.

More fundamental concerns relate to the narrow range of dwellings available; to public

expenditure constraints on the numbers of dwellings that could be made available; and to the capacity to target assistance to the most appropriate groups. Even so, versions of this product still form the mainstay of government-sponsored provision. Indeed they are increasingly important, especially in the UK, because of the pressure to increase the numbers of dwellings of all types that are built and to include affordable housing in every large site.

The other major development came in the UK in the late 1990s with the introduction of *Homebuy* - a government provided shared equity mortgage where the eligible purchaser could choose an existing dwelling and obtain an interest free equity mortgage on 25% of the value of the dwelling. Again the purchaser had a right to pay back that mortgage at any time based on the then current valuation and so become a 100% owner.

In addition there are initiatives which involve shared equity into perpetuity usually in the form of a Community Land Trust keeping a proportion, often 20%, of the capital value to cover the land element and to help the Trust maintain the property as affordable into the longer term.

These products avoided many of the difficulties associated with a broader based market scheme as government provided the money and the first charge on the dwelling went to the financial institution providing the traditional mortgage. The valuation of the specific property for sale or mortgage repayment was administratively determined by the district valuer and tended to favour the purchaser. Finally all the schemes were ultimately funded by public expenditure, so the private market incurred few additional risks. However, these schemes were necessarily small scale and available only to a narrow range of potential purchasers who met the government's criteria - in the UK in particular access has been increasingly limited to key workers. The schemes have not benefited from the development of a secondary financial market because of their small scale, because the products have not been standardised, and because of the large government involvement. As such while they may effectively assist a small number of households into owner-

occupation they make little or no impact on consumers more generally and do nothing to improve the efficiency and offering of the housing finance market.

Market Based Developments in the UK

In the UK the extent of pure market interest has been very limited. Banks and building societies have been prepared to fund the mortgage element of shared ownership but have been unhappy about the lack of standardisation and the small scale of the product - both of which increase transactions costs and make it extremely difficult to move the mortgages off balance sheet.

There were a small number of developer initiatives, especially during the recession of the early 1990s, where the purchaser has been enabled initially to purchase less than 100% and to staircase up as their circumstances improved. These were basically provided to improve cash flow while at the same time maintaining values on the developer's balance sheet and providing a discount to the part purchaser. Over the last few years these types of product have been out of favour because market conditions have made it easy for developers to sell at full price. It will be interesting to see whether they re-emerge if and when demand is less buoyant.

Other niche markets that have seen some growth are mortgages for the part purchase of vacation property such as timeshares and golfing villages. Equally there has been interest, but very little activity, in relation to equity release schemes for the elderly, which involve the owner giving up part of the value of the property rather than paying interest on a loan.

The most directly relevant market development is another government-sponsored product introduced in 2006 called *Expanded Open Market HomeBuy*. As with *Homebuy* the purchaser gives up 25% of the equity in return for two distinct mortgages: one for 12.5% from the government which is interest free and one, also 12.5%, from the lender who also provides the traditional mortgage, where an interest charge is made after five years. The objective from the point of view of government is to stretch the public funding available but also directly to involve the financial institutions in

taking up equity products. The process has proved extremely difficult, in part because of the regulatory requirements of the Financial Services Authority that regulates financial institutions. Only five main lenders have signed up as providers and the terms and conditions - eg in one case shared appreciation rather than shared equity - do not provide good value for money. In part as a result, the government in July 2007 has re-introduced a modified version of the earlier scheme, now called *Open Market HomeBuy*, which involves a 17.5% mortgage provided by the government and thus puts no pressure on the private sector to provide anything other than a traditional mortgage. At the same time the government has issued a challenge to the industry to develop other shared equity schemes that might help to alleviate problems of access and affordability.

The market product which has the most capacity to enable consumers to diversify their investment in housing is the property bond. This enables people to invest in a managed portfolio of properties where the value is based on a relevant price index. In principle the assets behind these bonds could include owner-occupied housing equity, although at present this is not the case. These bonds enable people to invest in a range of properties rather than a specific dwelling as well as enabling tenants to buy a share in potential residential capital appreciation.

Overall therefore, although the benefits of shared equity are recognised by both governments and the finance industry in the UK there has been very limited appetite for market innovation and no sign of an unsubsidised instrument emerging which is directly based on shared equity.

Market Based Developments in Australia

The situation in Australia appears far more dynamic with both governmental and private initiatives. The starting point for market interest was the recommendations of a Taskforce set up by the Prime Minister, which reported in 2003. The recommendations were based on the Housing Partnership model first put forward by Caplin in the USA. This was based on the economic principle that individuals should want to use the finance market to transfer some of the risk associated with the owner-occupied

home to others. The model put forward by the Taskforce suggested that the purchaser should fund their part of the property with a conventional loan together with any subsidy (such as the first-time buyer grant available to some households in Australia). The investor (ie the secondary owner) would receive a return made up of any increases in capital value together with a rent/dividend on the equity owned which would be deferred until sale. This element would be paid for by increasing the share of the equity owned by the investor - so for instance an investor might own 30% at the time the agreement is made but 50% twenty years later when the property is sold.

The benefits of such a model are seen to arise from the reduction in portfolio risk as housing as an asset class is relatively uncorrelated with most other assets. Such a model provides flexibility for both lender and borrower and reduces the borrowers' outgoings at periods when they are cash constrained. However it also increases the house price risk faced by the borrower because reductions in prices are not transferred.

So far the specific proposals made by the Taskforce have not been directly acted upon. However, the report provided a stimulant for a range of innovative potential products. Three examples of the products that have been developed over the last three years are those from Firstfolio/Residex; Greenway; and Macquarie/Rismark.

The Firstfolio/Residex product, a shared appreciation mortgage, was originally proposed in early 2005. It was based on the idea of reducing the rent/dividend element of the return on the equity share by increasing the proportion of capital value transferred - with that capital value determined by a local house price index. The issuer's intention was to raise significant finance from the market to fund the offer and to target first time buyers. However, no funding had been raised at the time that the finance arm of the organisation was restructured, although attempts were still being made. In early 2007 there was still no information available about progress on the initiative.

Greenway's product appears to be very similar except for its potential marketing strategy. The borrower may take up to a 50% loan in return

for 80% of the capital gain - the details of what happens if there is a capital loss is less clear but implicitly the loan has to be repaid in full. Up to \$Aus1 billion is to be raised on the market from institutional investors, although there is no evidence as yet of market activity. The intention would be to securitise the mortgages and to recycle the proceeds. The likely take up is expected to come from retirees (ie the reverse mortgage market) and aspirational up-graders. It is not expected to appeal to first time buyers.

The Macquarie/Rismark product was announced in late 2005 when they stated that they wished to raise \$ Aus1 billion to invest in their planned shared equity scheme - although the details of that scheme were not specified. In late 2006 a much smaller amount - \$Aus25 - was provided by an unlisted company and in March 2007 they announced that they would launch an equity financed mortgage in July through the Adelaide Bank. The product was based on a zero interest equity share loan of up to 20% of the property value in return for up to 40% of any capital gain. The investor return would be tied to specific house price indices, which are now in place. It was intended to target the product at first time buyers as well as other aspirational purchasers facing cash constraints. However, while it is expected that the launch will go ahead there appear still to be only very limited funds available.

There is continuing interest among potential lenders aiming to develop shared equity mortgage products of this type - and indeed a great deal of work has been done, particularly by Macquarie/Rismark. Even so, there has been very little real progress over the last four years and no products are actually on offer in the market. Nor is there significant evidence of institutional interest in funding these products.

In addition to the market based products, there is increasing government and state interest in increasing the availability of new build shared ownership products and in finding ways of using public sector land to support the provision of affordable housing. Charitable providers are also involved in schemes aimed at enabling them to use their own equity to expand supply through a range of shared ownership products. All of these schemes aim to lever in large scale private finance in order to

stretch available public funding and to sweat public and charitably owned assets. In this context, unlike in terms of market instruments, the Australian experience is probably slightly less developed than that in the UK.

Emerging Issues

The best evidence on how markets are responding to the apparent opportunity to develop new products funded by institutions and using securitised instruments comes from Australia.

First, on consumer interest and thus demand: interest is highest not among younger and cash limited households but rather among those in the highest income quartile who are looking to balance their portfolios more effectively. Equally provider interest appears to be more among those looking for reverse mortgages than those trying to become first time buyers. In addition there may be particular niche markets such as vacation homes.

Second, there are increasing concerns about regulatory risk. The products are complex and consumers need to be well informed. The potential for mis-selling and the possibility of poor valuation processes is considerable and more general experience in the mortgage market tends to make institutions risk averse.

Third, generating the benefits of lower cost funding involve the use of both secondary markets and the transfer instruments based on capital values that are not dependent on the sale of the specific property. There must therefore be robust price indices in place before investors will come forward. Such price indices present major problems, especially in countries where properties have very individual attributes. In this context even repeat sales price indices cannot solve quality adjustment problems. Equally, there is significant potential for moral hazard behaviour where the occupier runs down the value of the property and limited incentives for improvement investment.

Most importantly perhaps long term investors are proving difficult to find, in part because of scepticism about the possibility of continuing capital appreciation; in part because of the uncertainties about tax treatment for particular instruments; and in part just because scale is

necessary to generate significant cost reductions and risk transfer - and it is simply unclear that there is enough demand to make this possible.

These concerns are mirrored in the discussion about developing market products in the UK. There is no real evidence of large-scale demand for these products even though there is clear potential, especially in the context of equity release.

In both countries the evidence suggests that shared equity products to assist access into owner-occupation need government support and will generally be short term - in the sense that households will wish to staircase into 100% ownership as quickly as possible. Both of these factors limit private sector involvement.

Perhaps most importantly, in both countries there is very little evidence that consumers see the possibility of shared equity products in the same way as a traditional mortgage. People are happy to regard themselves as owners even when they have mortgages of 90% or even 100% of the value of the property. However this mindset does not seem to transfer easily to a part ownership product where the secondary owner is a financial institution. The risks involved in a relatively unknown product seem to be regarded as much higher than those associated with concentrating wealth in a single dwelling.

Overall therefore shared equity still appears to be an idea whose time has not yet come. Even so there is evidence of progress both in terms of better government- sponsored products for first time buyers and the possibility of growth in niche products in the market sector. Over time ways will probably be found to realise the very real potential benefits from these approaches - but there is still a long way to go.

Further Reading

M Berry, C Whitehead, P Williams and J Yates *"Financing Affordable Housing: a critical comparative review of the UK and Australia"*, AHURI, 2006

A Caplin, S Chen, C Freeman and J Tracey, *"Housing Partnerships: A new approach to a market at the crossroads"*, MIT Press, 1997

Has the Rise in Debt Made Households More Vulnerable?¹

by Nathalie Girouard, Mike Kennedy and Christophe André²

Introduction and Summary

Over the past decade, household debt has risen to record levels in a number of OECD countries. The large size of these debt run-ups, coupled with, in several instances, changes in the characteristics of some of the relevant instruments, are estimated to have raised the sensitivity of the household sector to changes in interest rates, asset prices and incomes (Debelle, 2004). In this sense, the household sector may have become more vulnerable to adverse shifts in these variables.

This paper begins by reviewing, for a number of OECD economies, macroeconomic developments in household balance sheets and incomes over the past two decades. It then examines micro-level information to provide a more recent cross-sectional snapshot of the household sector. The purpose of this paper is to assess household financial vulnerability. Following the plan of the paper, the main findings are:

- The rise in household debt, in particular mortgages, to historical levels in a number of countries has been driven by a combination of favourable financial conditions and buoyant housing markets. There have been, as well, a number of supply-side innovations in credit markets that have eased the access to credit for lower-income borrowers and reduced financial constraints for first-time homebuyers.
- While debt, particularly mortgages, has risen sharply, so has total household net wealth, reflecting mostly the sharp appreciation of property values and an increase in homeownership rates as well as, after 2001 the recovery in equity markets. This large stock of assets provides households with a financial cushion against a negative shock. That said, households in a number of countries have leveraged balance sheets and the sensitivity to house-price and interest rate developments has likely increased.
- The fraction of disposable income devoted to servicing debt (interest and principal payments) has also been moving up. Part of this rise, however, is compositional, reflecting increasing homeownership rates, driven by improved access to credit markets for first-time purchasers who tend to have higher debt and lower income levels. Despite these developments, however, mortgage-delinquency rates have been trending down over the past decade.
- Household surveys in various countries that identify debt holdings by age and income group provide a complementary perspective on the issue of vulnerability. Studies using such micro data suggest that most of the debt is held by households better able to manage it. In particular, the major part of debt is held by higher-income households, who also spend a smaller proportion of their disposable income servicing debts. Lower-income households, with less ability to service debt, do not hold that much and, as such, the spillover effects from this group to the rest of the economy are perhaps not large.

Whether the situation remains benign or not depends on what happens to interest rates, asset values (particularly house prices) and incomes. In the event of adverse developments in these variables consumption and the wider economy would be affected. Looking, for instance, at the implications of a sharp and unanticipated rise in interest rates, higher debt levels would imply that a larger proportion of income would be devoted to debt servicing, the size of which would depend importantly on the maturity structure and characteristics of the debt. The resulting reduced capacity to service debt could also adversely affect households' access to credit and accordingly their ability to smooth consumption. Balance sheets would tend to deteriorate and households would be expected to increase saving.³ Estimates presented in the final section of this paper point to significant effects of changes in net wealth on household saving rates in a large number of the countries studied. As well, the deterioration in balance sheets could further affect access to credit. There could also be negative feedback effects through worsening income.

¹ This paper has been already published as an OECD Working Paper (No. 535), ECO/WKP(2006)63. With kind permission of OECD (Economics Department), it is now published in *Housing Finance International*.

² Nathalie Girouard is principal administrator in the Office of the Secretary General of the OECD. Mike Kennedy is Head of the General Assessment Division in the Economics Department of the OECD. Christophe André is an economist in the Economics Department of the OECD. The authors thank Sebastian Barnes, Jorgen Elmeskov, Michael Feiner, Felix Huefner, Vincent Koen, Paul van den Noord, Laura Vartia and Tadashi Yokoyama for helpful comments. They also thank individual country experts Juan Ayuso, Phill Briggs, Matthew Corder, Umar Faruqui, Risto Herrala, Gerbert Hebbink, Johannes Hoffman, Martin W. Johansson, Jonathan Kearns, John Kelly, Trinh Lee, Kevin B. Moore, Kenneth Juhl Pedersen, Mathias Persson, Grant Scobie, Elmar Stoess, Paolo Finaldo Russo, Kari Takala and the European Central Bank for providing micro data statistics and useful discussions, Anne Eggimann and Sarah Kennedy for excellent technical assistance.

³ The effects on spending from changes in housing wealth have been estimated to be larger in English-speaking countries than in some Continental European countries, see Catte et al. (2004).

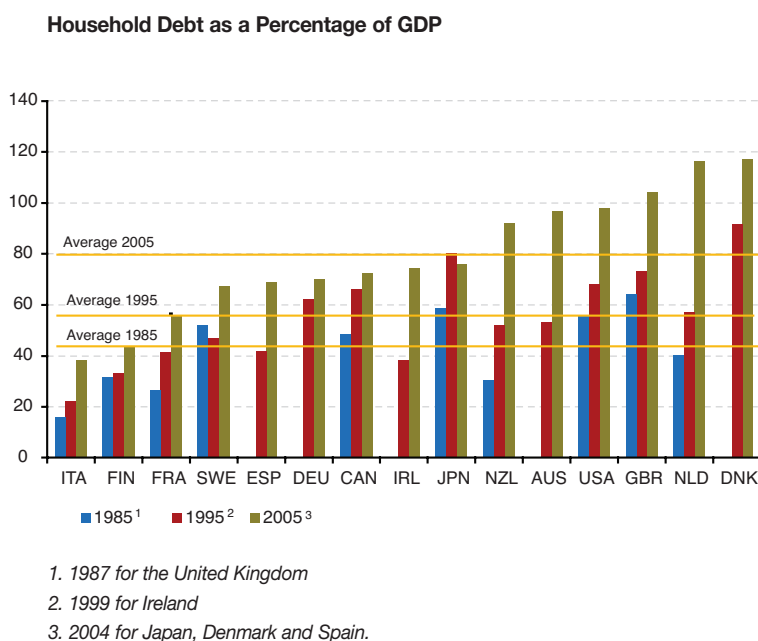
The Debt Run-Ups: Broad Trends and Some Underlying Causes

Looking at a group of 15 OECD countries for which data are available, total household borrowing, as a proportion of GDP, has increased considerably over the past two decades (Figure 1, upper panel).⁴ However, the process has not been uniform across countries and, in 2005, debt levels ranged from below 40% of GDP in Italy to above 100% in the United Kingdom, the Netherlands and Denmark.

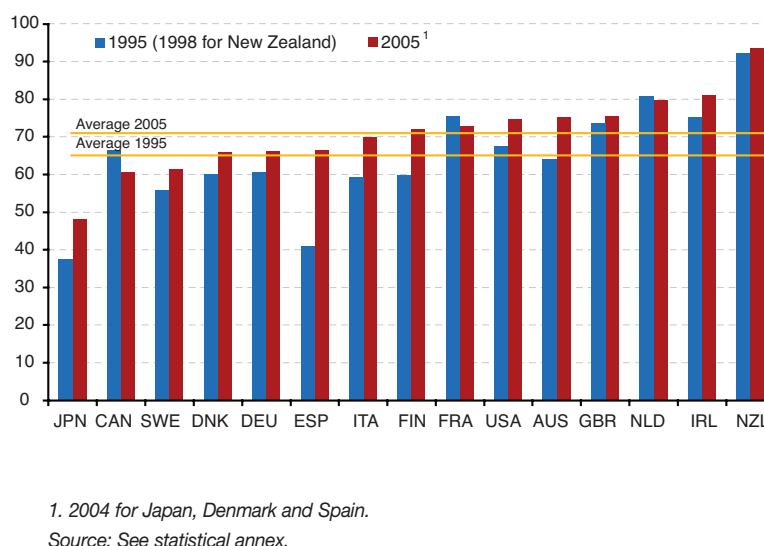
The share of mortgage debt has been rising over time, accounting for approximately two thirds of total household debt in most countries by 2005 (Figure 1, lower panel). Similarly, credit card debt, which is a substantially smaller portion of household liabilities, has risen rapidly and spread to a wider range of social groups (for instance, in the United States, the United Kingdom and Australia) but accounted only for less than 5% of total household debt (Reserve Bank of Australia, 2006, Bucks et al., 2006, and Del-Rio and Young, 2005). In Korea, in contrast, the share of credit card debt has been declining from the high levels reached at the peak of the boom-and-bust credit card cycle in 2002 (OECD, 2005).

Underlying these debt trends have been buoyant housing markets and favourable financing conditions. These developments have been reinforced in several countries by financial liberalisation and innovation,⁵ which have facilitated the access to credit of borrowers who were previously denied it and relaxed financing constraints on first-time homebuyers. One result is that homeownership rates have increased. Transactions and search costs have also been lowered and borrowing against existing collateral (mortgage equity withdrawal) has become cheaper and more readily available (Klyuev and Mills, 2006; Reserve Bank of Australia, 2006; and Danmarks Nationalbank, 2006). These, as well as, other reforms have allowed existing borrowers to expand their balance sheets, in the process, raising their net worth. In the wake of these changes, several

Figure 1 - Trends in Household Debt



Mortgage Debt as a Percentage of Household Debt



⁴ The data are not strictly comparable across countries due to different statistical definitions of the household sector. For example, in some countries, unincorporated businesses and non-profit institutions serving households are included in the household sector data, whereas in others they are not. See the Statistical Annex for further details.

⁵ See Girouard et al. (2005) for a cross-country overview of financial innovations in mortgage markets.

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countries with initially lower debt ratios have seen stronger debt growth compared with those with initially higher debt ratios. This has been particularly noticeable in Australia, the Netherlands, New Zealand and Spain. For a number of new European Union Member countries, one study suggests that the convergence in living standards towards that of the European Union average has also contributed to this rapid credit expansion (Coricelli et al., 2006). Another important factor was the convergence of interest rates towards the comparatively low German levels with the creation of the single currency.

Macroeconomic Measures of Vulnerability *Assessing the Health of Household Balance Sheets*

Household debt, expressed as a ratio of disposable income, has increased rapidly in most of the countries under study (Japan and

Germany excepted). At the same time, there have also been important developments on the asset side of household balance sheets, and net wealth (total wealth less liabilities) has risen significantly (Table 1). By 2005, net wealth had grown to a level of about seven times disposable income in several countries. The recovery in equity prices since the bursting of the dotcom bubble in 2000-01 provided a boost to household wealth, but the gains for the most part have been due to a rise in the non-financial wealth component (Figure 2, upper panel), fuelled by large house-price increases. Such rises have been particularly pronounced in New Zealand and Spain. By contrast, in Germany and Japan, where declines in house prices have occurred, a notable increase in the share of housing assets in household portfolios was not recorded. In these economies, household gross wealth peaked earlier in the 1990s and has since stabilised.

The lower panel of Figure 2 shows that the increase in mortgage debt has, for the most part, been accompanied by gains in net non-financial wealth. The collateral position of households has accordingly improved in the majority of countries since the early 1990s, with Japan and Germany being exceptions. While part of the rise in assets may be illiquid, their large size provides households with a cushion that can be used to fund consumption or service debt, should they be hit by an adverse shock. Empirical evidence for several countries including the United States, the United Kingdom, Canada, Australia and New Zealand, all of which have fairly flexible mortgage markets, has shown that households with high housing wealth are better able to smooth consumption in the face of shocks (see for instance Beaumont, 2005; Lustig and Van Nieuwerburgh, 2004; and Hiebert, 2006).

Table 1 - Household Debt and Net Wealth (Per Cent of Annual Disposable Income)

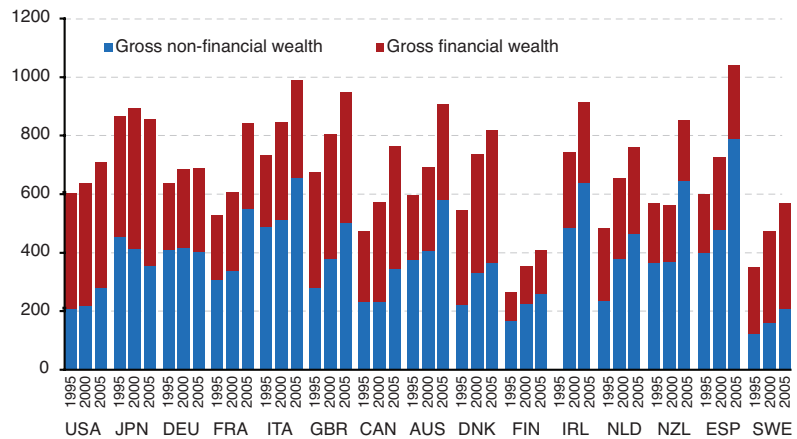
	Debt				Net wealth		
	1995	2000	2005		1995	2000	2005
United States	93	107	135		510	575	573
Japan	130	136	132	*	736	750	725
Germany	97	111	107		541	575	578
France	66	78	89		461	547	752
Italy	32	46	59		702	820	936
United Kingdom	106	118	159		569	750	790
Canada	103	114	126		370	527	640
Australia	83	120	173		514	567	734
Denmark	188	236	260	*	357	524	562
Finland	64	66	89		202	302	319
Ireland	-	81	141		-	618	775
Netherlands	113	175	246		369	528	515
New Zealand	96	125	181		472	445	670
Spain	59	83	107	*	540	646	935
Sweden	90	107	134		262	387	436

Note: * for year 2004 instead of 2005. Debt refers to total liabilities outstanding at the end of the period. Net wealth is defined as non-financial and financial assets minus liabilities. Source: See statistical annex.

The balance sheet positions of households are not, however, without risks. While in most countries, household net wealth positions look healthy, in several, leverage, defined as the ratio of debt-to-net assets, has been trending upward, raising vulnerability to asset-price declines (Figure 3).⁶ There are a number of motivating factors behind these developments. For example, households have borrowed (either directly or through mortgage equity withdrawals) to finance pension and other asset acquisitions, some of which receive favourable tax treatment.⁷ However, leverage has also been driven by buoyant housing markets, which has encouraged buyers to take out large mortgages on expectations of capital gains. For a number of countries, these price gains have been realised, and leveraged positions have increased only moderately. Nonetheless, even for these economies, given high levels of mortgage debt, leverage positions remain sensitive to changes in interest rates and asset prices (particularly house prices).

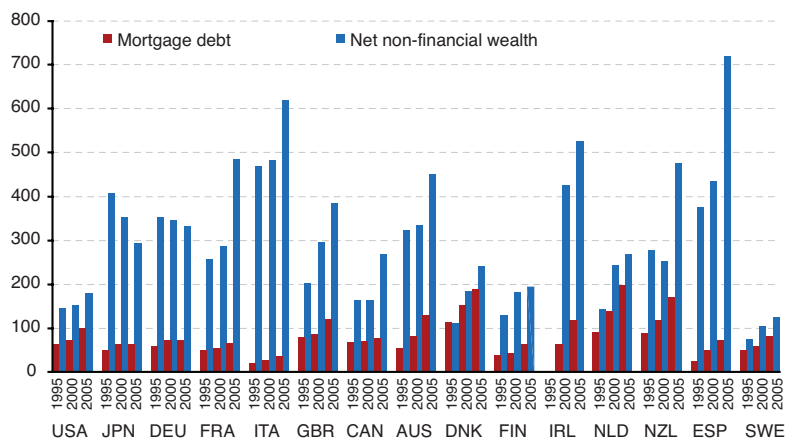
Figure 2 - Household Wealth

Gross Wealth and its Components (Per Cent of Disposable Income)



Note: The latest data for Japan, Germany, Italy, Denmark and Spain are for 2004.

Net Non-Financial Wealth and Mortgage Debt (Per Cent of Disposable Income)



Note: The latest data for Japan, Germany, Italy and Spain are for 2004. Net non-financial wealth is defined as non-financial wealth minus mortgage debt.

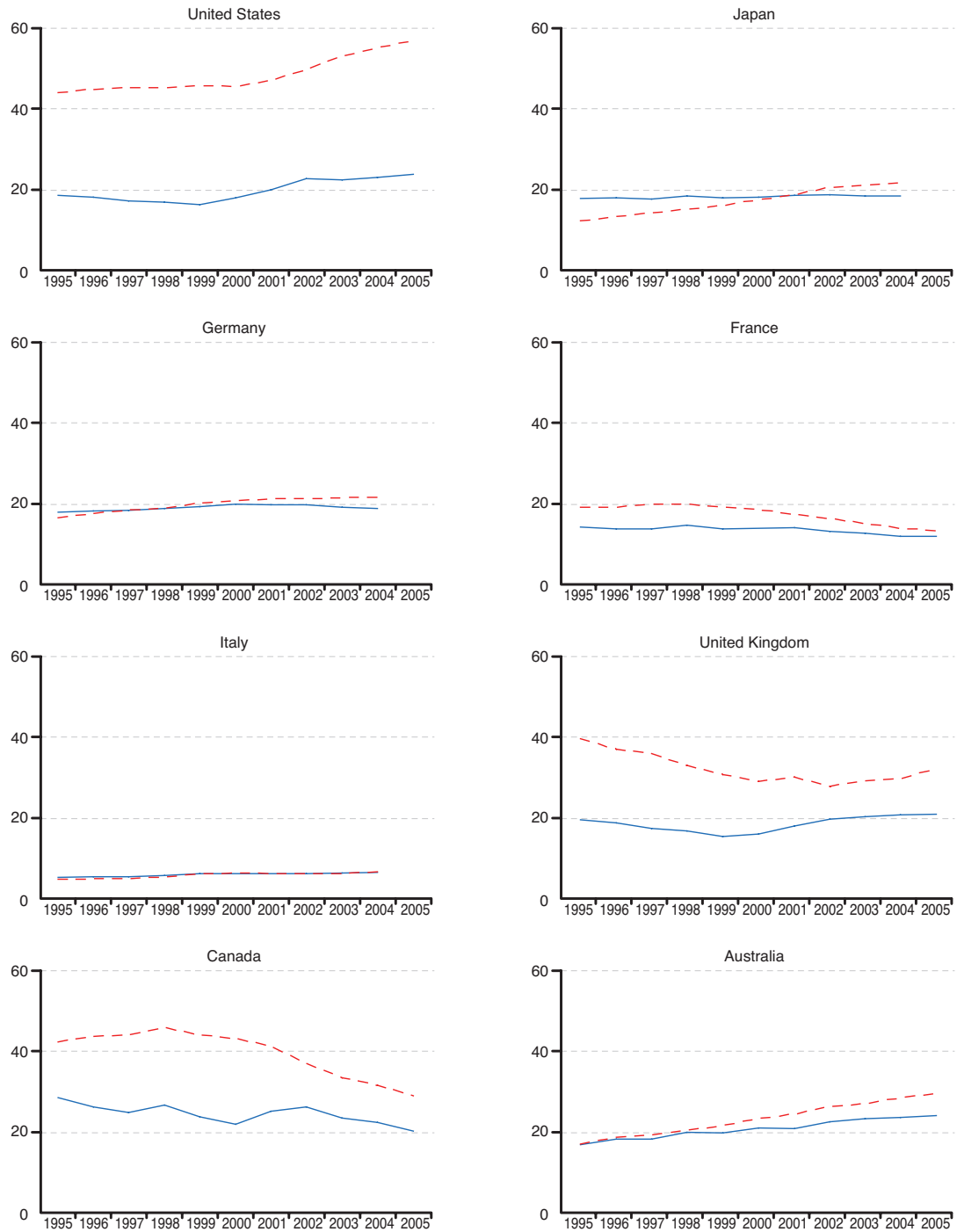
Source: See statistical annex.

⁶ Cross-country comparisons of household wealth are difficult to make because of institutional differences, inter alia, the sizeable amount of wealth held in the form of pension assets and family trusts outside household balance sheets. See Briggs (2006) for example in the case of New Zealand.

⁷ See Catte et al. (2004), which summarises the different tax regimes affecting residential property prices.

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Figure 3 - Households Leverage Ratios (*Liabilities as a Percentage of Net Wealth*)

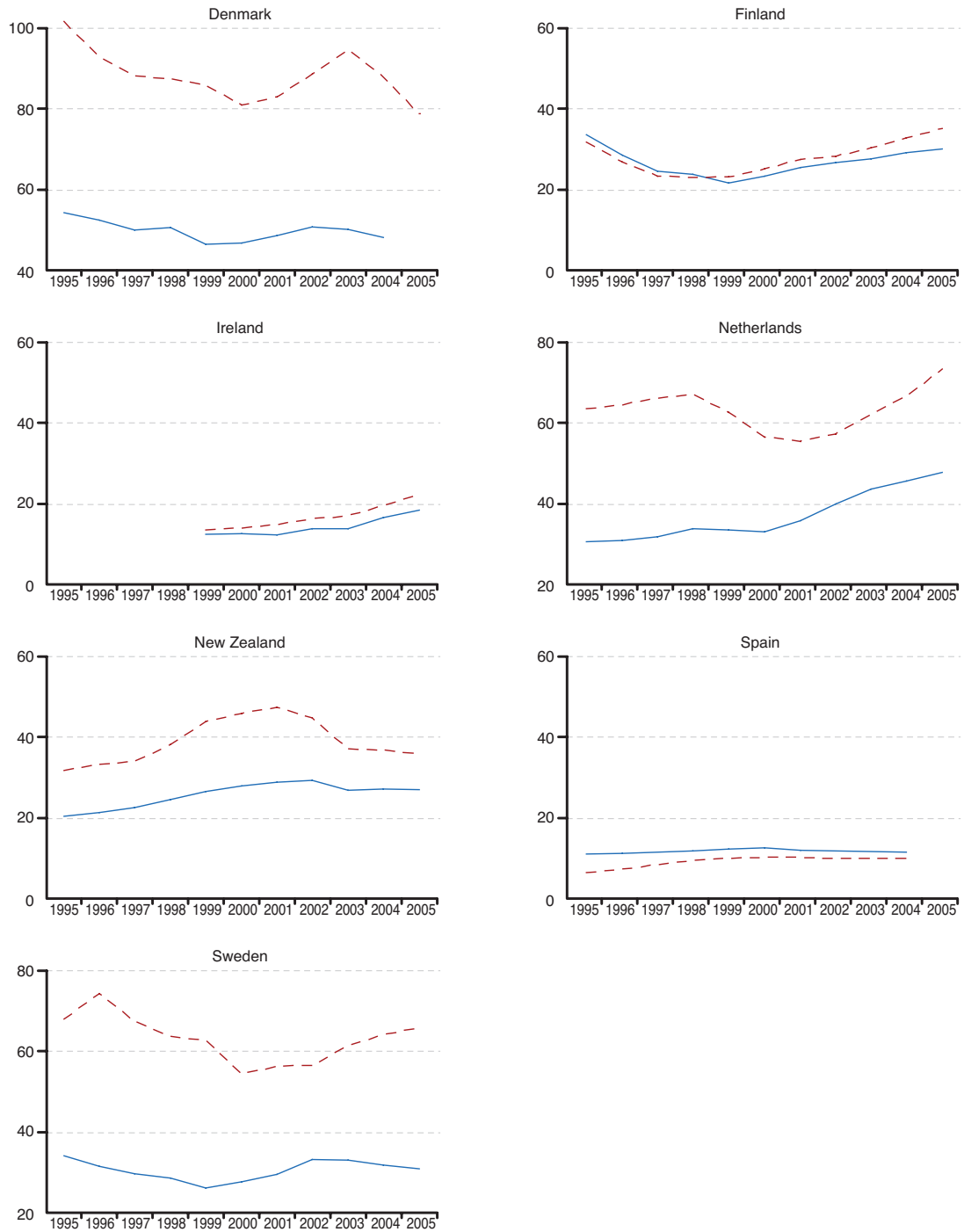


Note: Total leverage is defined as total liabilities divided by net wealth and non-financial leverage as mortgage debt divided by non-financial wealth. Source: See statistical annex.

— Total Leverage
 - - - Non-financial Leverage

HAS THE RISE IN DEBT MADE HOUSEHOLDS MORE VULNERABLE?

Figure 3 - Households Leverage Ratios (Continued) (*Liabilities as a Percentage of Net Wealth*)



Note: Total leverage is defined as total liabilities divided by net wealth and non-financial leverage as mortgage debt divided by non-financial wealth. Source: See statistical annex.

— Total Leverage
 - - - Non-financial Leverage

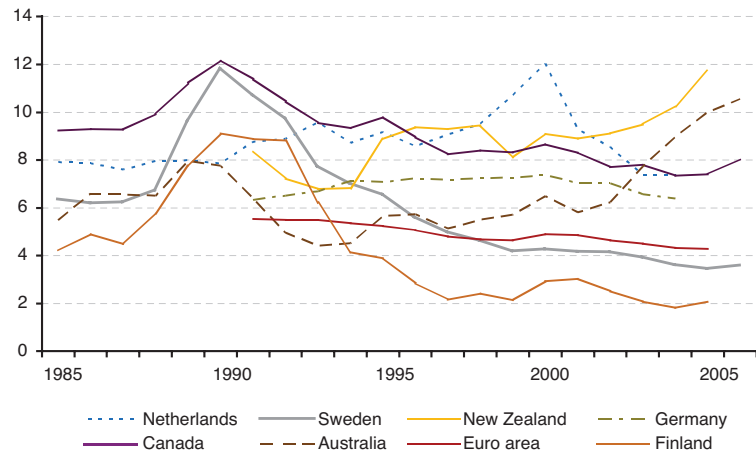
Evaluating Households' Debt-servicing Capacity

A sharp rise in interest rates or a negative hit to incomes, in addition to any effect it would have on net wealth positions, would push up debt-service ratios - the fraction of disposable income devoted to debt repayment. The speed and extent of any rise in repayments would be related to the characteristics of the debt (most importantly, its maturity and composition between fixed and variable rate instruments). A rise in debt-service burdens could constrain households' access to credit, affecting their ability to smooth consumption in response to shocks. Two measures of debt-servicing capacity are examined here: one based on interest payments only and another that takes account of interest payments and principal repayments (Figure 4).^{8,9} The interest-and-principal measure is more comprehensive and more likely to provide a better picture of how households are faring but it is available for only a limited number of countries. Households facing debt service burden of over one third of their income and total debt-service costs (including student loans, autos loans and credit card payments) in excess of 40% of their income can be categorised as risky borrowers (see for instance Alexander, 2006 and ECB, 2005).

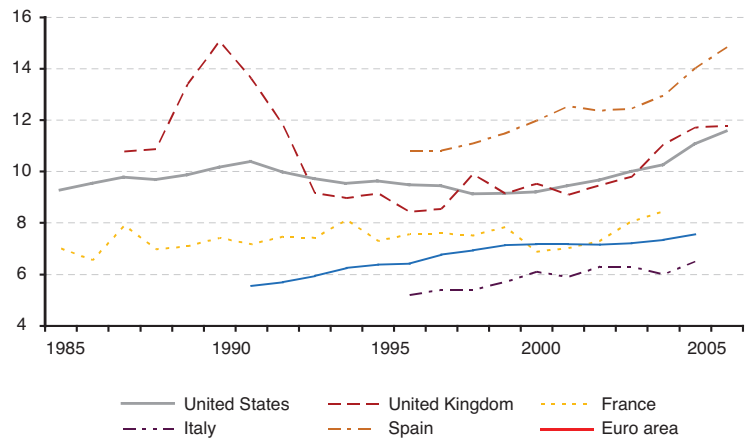
The interest-service burdens have been relatively stable since peaking in the late 1980s and early 1990s (the exception is the Netherlands), with the general increase in indebtedness having been mostly offset by declines in borrowing costs (Figure 4, upper panel). However, more recently, in Australia and New Zealand, the interest-burden ratio has risen rapidly, reaching respectively 8.5 and 12% of disposable income in 2005. The more comprehensive measure of the debt-service burden has increased for all of the countries for which data are available (Figure 4, lower panel). In the United States, the United Kingdom, France and Italy, the debt-service ratio has recently started to rise slightly while in Spain, this ratio has been increasing

Figure 4 - Household Debt Service Burdens

Interest Only Debt Service Ratio (Percentage of Disposable Income)



Interest and Principal Debt Service Ratio (Percentage of Disposable Income)



Note: Data for the United States and France refer to mortgage debt and for other countries to total household debt. Source: National central banks and European Central Bank.

continuously over the past decade. A broader measure, produced by the US Federal Reserve Board, takes account of additional obligations like automobile lease payments, housing rents, insurance and property taxes to

calculate a financial obligations ratio. This measure has been rising steadily over the past two decades and now stands just over 19% of disposable income, compared with just over 11% for mortgages.

⁸ Data on debt-servicing burdens are not strictly comparable across countries. Variations in estimates are based on different assumptions relating to the average maturity of households' loans, the structure of debt in terms of mortgage loans and other loans and the interest paid on different kinds of household loans.

⁹ Debt-service ratios for homeowners and renters are distributed differently across loan types. Mortgages are the dominant component of homeowners' debt, whereas credit cards, auto and student loans are the major components of renters' debt. As a result, changes in mortgage interest rates will affect the debt-service ratio only of homeowners, whereas changes in consumer loan interest rates will disproportionately affect the debt-service ratio of renters. In the United States, the debt-service ratio for renters is substantially higher than that for homeowners because of the greater share of income devoted to rent and consumer debt payments, see Bucks et al. (2006).

Several factors are affecting trends in the aggregate debt-service ratio. First, the composition of the pool of homeowners has been changing. Over the 1990s, homeownership has risen, in part because of new mortgage products facilitating housing acquisition by borrowers with limited funds for a down payment. These new homeowners, who would have previously been renters, have entered the homeowner market with high debt levels relative to their income and this has been a contributing factor to the rise in the aggregate debt-service measure. In the United States, the increase in homeownership during the 1990s was concentrated among households with limited funds for a down payment (see Dynan et al., 2003 and Bucks et al., 2006). Second, loan maturities have increased in a number of countries and this has brought down annual amortisation.

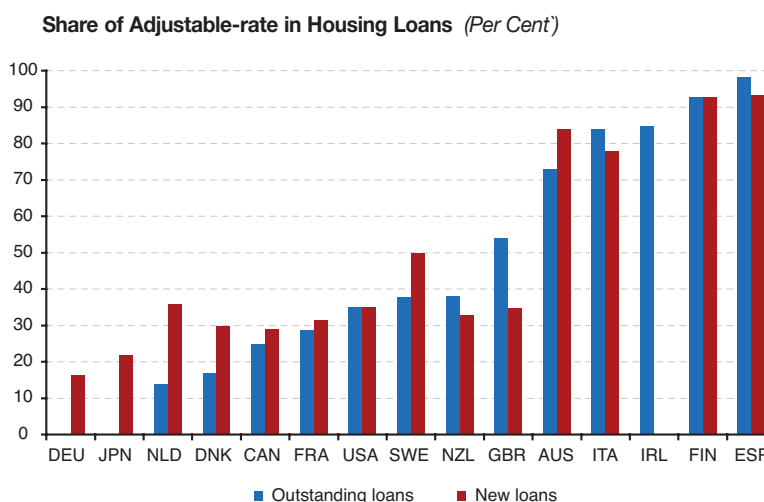
The third factor affecting households' debt service burden is housing equity withdrawal and re-financing. These vehicles have allowed homeowners to take advantage of lower interest rates to reduce their monthly payments and, in several countries, to extract some of the built-up equity in their homes.¹⁰ Mortgage refinancing at lower rates clearly reduces debt service burdens, even if most of the proceeds are spent. On the other hand, the housing equity withdrawal effect is ambiguous. It increases household debt service burden, even if most of the proceeds are reinvested. But if the proceeds are used to payoff debt with higher interest rates, the debt service burden will decrease. In the United States and the United Kingdom, these two effects seem to have been partly offsetting. Some of the equity extracted has been used to pay down more expensive consumer debt or to make purchases that would otherwise have been financed by more expensive and less tax-favoured credit. At the same time, a number of homeowners have also taken advantage of house price inflation to increase their borrowing by re-mortgaging.

Another development that has implications for vulnerability is the changing composition of debt away from fixed rate and towards more flexible instruments. These newer types of loans come in several forms, including instruments with rates that move with market interest rates, products that allow borrowers to pay only interest instead of the conventional interest-plus-principal or to pay less interest than is accrued (negative amortisation loans that lead to rising loan principal balances), as well as loans with various combinations of initially reduced rates and rapid reset conditions. These instruments have the effect of lowering initial monthly payments but at the expense of incurring the risk of larger payments later should mortgage rates be readjusted upward. However, the flexibility of mortgage markets in several countries has allowed households to switch to fixed-rate instruments very rapidly and with little cost. For example, the United Kingdom, which has traditionally been regarded as a variable rate

country, is reporting a higher proportion of initial fixed rate mortgage loans than variable rate loans since mid-2005.¹¹ The contracting of mortgage loans with adjustable rates has been generally more prevalent in the United Kingdom, Italy, Australia, Finland, Ireland and Spain than in the other countries (Figure 5a).

To date, there have been few signs at the aggregate level that households are having trouble meeting payment obligations. A commonly used indicator of debt-repayment ability, the delinquency rate,¹² shows that arrears on housing loans held by banks have been trending down, or have remained quite low relative to the average of the past decade (Figure 5b - overleaf). Indeed, the downward trend in delinquencies has reflected growing credit availability, falling interest rates and longer maturities. However, lags in the response of arrears to increasing debt ratios may be significant.¹³

Figure 5a - Adjustable Rate Loans and Vulnerability



Note: Latest year for which data are available. For further detail, see statistical annex.
Source: See statistical annex.

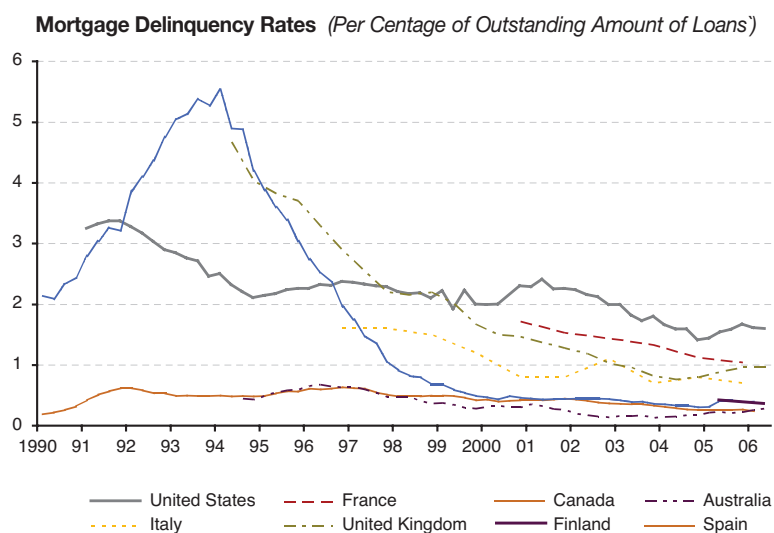
¹⁰ See for instance Greenspan and Kennedy (2005), Klyuev and Mills (2006), Schwartz et al. (2006) and Riksbank (2005b) for a discussion of the effects of mortgage-equity withdrawal on consumption.

¹¹ For a comprehensive review of the different types of mortgage interest rates in Europe, see European Mortgage Federation (2006).

¹² The standard definition of credit delinquency is loans that are in repayment default for at least three months. The main difference across countries is how these loans are defined, i.e. how long it takes before the loan can be judged as non-recoverable and hence can be written off as a loss for the credit institution. The timing of this process depends on national regulation. In France and Italy, the time before a loan can be written off is particularly long, thus the same loan can be counted as non-performing for several years while in other countries it will be considered as non-performing for no more than six months. This partly accounts for the fact that in France and Italy the stock of delinquency loans as a proportion of the total loans' stock is larger (see Moody's, 2003).

¹³ In the literature, there is no agreement about which financial indicator is the most important predictor of households' delinquency, see, for example, Rinaldi and Sanchis-Arellano (2006); Duygan and Grant (2006); Diaz-Serrano (2004); and May and Tedula (2005).

Figure 5b - Adjustable Rate Loans and Vulnerability



Note: Loans refer to mortgages for all countries except Finland and Italy where they include all loans to the households sector. For Italy, they refer to new bad debts during the year as a percentage of outstanding loans. Source: See statistical annex.

The Level of Risks Borne by Credit Institutions Appears to Have Increased

The relaxation of credit standards and the growing use of payments reduction features in mortgages have, however, increased credit risk in mortgage markets (Frankel, 2006). Several banks and other private financial institutions have recently specialised in offering “affordable” loan products. These non-conventional housing loans with weaker standards are likely to appeal more to consumers with low credit ratings who may find it difficult to obtain finance from traditional sources. These mortgages are often used to consolidate existing (secured and unsecured) debts. In Australia and in the United States, for instance, a much higher proportion of non-conventional borrowers (compared with those who use more conventional instruments) are behind schedule on their loan repayments. According to the Reserve Bank of Australia (2005), nearly 4% of the value of securitised non-conventional loans was in arrears, compared to only 0.2% of both other

securitised and bank’s housing loans. In the United States, the delinquency rate for sub-prime mortgages is estimated to be around seven times that of prime mortgages. Moreover, in the United States, such loans accounted for less than 50% of government sponsored enterprises and pools issuance in 2001, but for more than three quarters in 2005.

At the same time, in several countries, banks and other private financial institutions have increased the proportion of mortgage loans in their overall lending to the households sector. In the United States for instance, the fraction of outstanding residential mortgage debt held by banks and other private institutions has risen by more than 10 percentage points although the share of government sponsored enterprises and pools dropped by 10 percentage points. While in these traditional financial institutions¹⁴ a uniform interest rate for almost all (prime or near prime) loans continues to apply, a pattern which is sustainable in part because the credit quality of the underlying household panel is good and rather homogeneous, in other

institutions, mortgage rates tend to vary in line with the default probabilities suggested by the standard distributions of households’ credit scores. On the other hand, increased securitisation of mortgage loans has allowed banks to improve their risk management.

Evidence From Micro Data

Aggregate measures of household debt only provide information about the position of the household sector as a whole or some notional average household. As such, these indicators mask important disparities in financial conditions across different segments of the population due to the substantial heterogeneity among households. In this respect, analysis using micro data indicators can potentially help identify pockets of fragility within the sector. This section summarises the results of various studies that have used household-level surveys for particular countries to analyse the financial position of the sector. While the methodologies may differ, the results of these studies may provide complementary information on vulnerability to that obtained from macro measures.¹⁵

Household Indebtedness by Age and Income Group¹⁶

The share of households with mortgage and non-housing debt varies greatly across countries (Figure 6), with Italy and Germany at one extreme and the Netherlands and the United States at the other. Repeated cross-sectional analyses report that, since the late 1990s, the fraction of households with debt has increased slightly in the United States and in the Nordic countries, while it has remained roughly unchanged in Canada and the United Kingdom. Such analysis is not available for the other countries studied here.

Debt-holding patterns are generally consistent with predictions from the life-cycle theory of consumer behaviour. The percentage of indebted households peaks among young households (less than 35 years of age) or

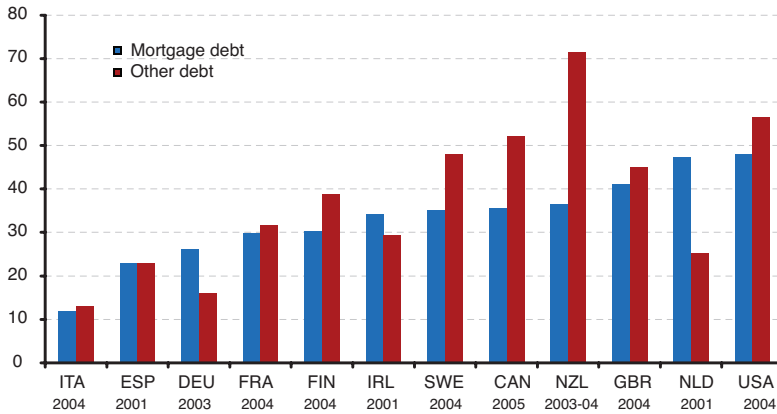
¹⁴ Traditional agency mortgage pools include securities by GNMA, FNMA, FHLMC, FAMC and the Farmers Home Administration.

¹⁵ The Statistical Annex reports the sources of the different household surveys.

¹⁶ Empirical analysis of the determinants of household debt using aggregate and cross section data include Magri (2002) for Italy; Barnes and Young (2003) for the United States; Tudela and Young (2005) for the United Kingdom; Central Bank and Financial Services Authority of Ireland (2005); Herrala (2006) for Finland; Zochowski and Zajackowski (2006) for Poland and Crook and Hochguertel (2006) for several OECD countries.

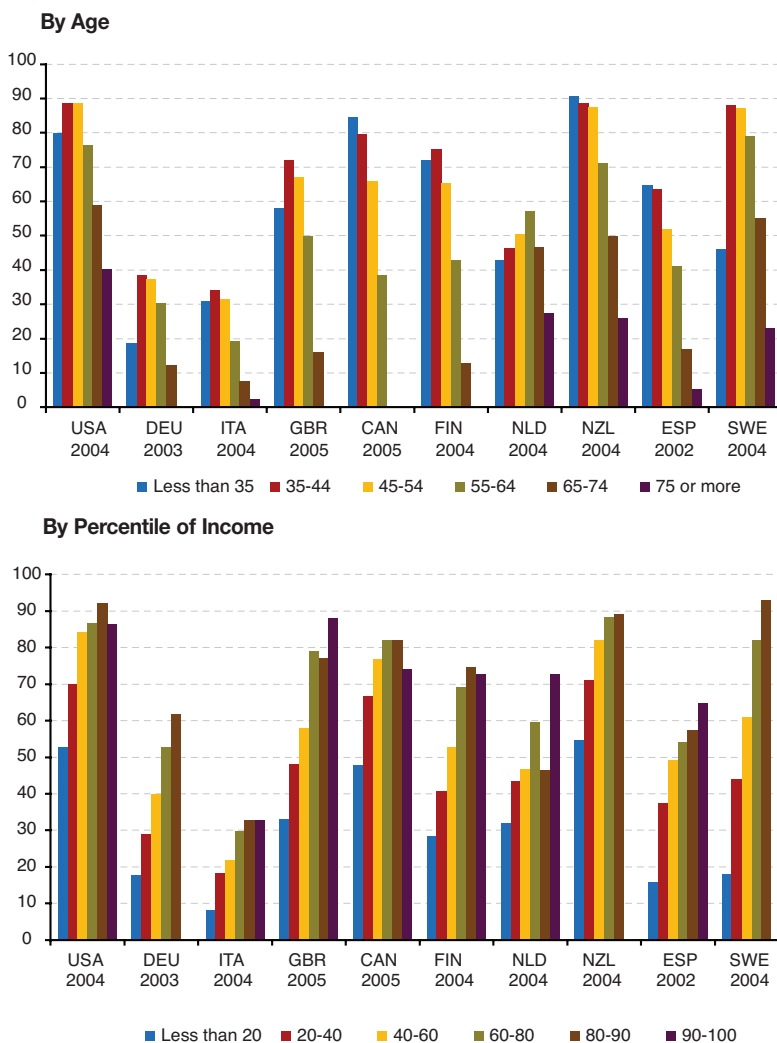
HAS THE RISE IN DEBT MADE HOUSEHOLDS MORE VULNERABLE?

Figure 6 - Proportion of Households Holding Debt (Per Cent)



Note: Some households may be holding both categories of debt. Source: See statistical annex.

Figure 7 - Debt Holding Patterns (Percentage of Indebted Households)



households in the middle-age groups (Figure 7, upper panel). Within these age groups, the percentage of indebted households often exceeds 70%. Debt holding declines sharply for those aged over 65, especially in the United Kingdom, Germany, Italy, Finland and Spain.

The lower panel of Figure 7 shows that borrowing has been mostly undertaken by households with the highest incomes. In the United States, the United Kingdom, Canada, Finland, New Zealand and Sweden, the proportion of indebted households in the upper income group exceeds 80%. The share of indebted households in the lower income group is nonetheless high in the United States, Canada and New Zealand, relative to other countries. For the countries for which a time perspective is available, the share of indebted households in the lowest income groups has increased the most since the end of the 1980s, reflecting the effect of the liberalisation of credit markets on the group of households which previously were most subject to credit rationing.

Note: For Germany, the United Kingdom and Finland, the last age group is 65 or more. For Canada, the groups are less than 35, 35-49, 50-64 and more.

Note: For Germany, New Zealand and Sweden, the last group is 80-100.

Source: See statistical annex.

HAS THE RISE IN DEBT MADE HOUSEHOLDS MORE VULNERABLE?

Table 2 shows the median value of debt holdings for those individuals with debt according to their age (as a percentage of per capita income). The median value of the debt is equal to the value that comes mid-way in the debt distribution. This measure is less sensitive to the extremes of the distribution and therefore provides a better picture of the typical household's debt than the average debt. The median value of debt peaks for households in the 35 to 44 age category for almost all of the countries under review, reflecting the larger number of first-time homebuyers in this group. Indeed, the share of the population at household formation age (24 to 44 year old) has increased rapidly since the mid-1990s in the United States, the United Kingdom, Australia, Ireland, Netherlands and Spain. Median debt in the middle age group (aged 45 to 54) has also been relatively high, and the fact that the number of households in this group has recently risen may help to explain the aggregate increase in debt.¹⁷ The median debt falls steadily through middle age before dropping off more sharply for those aged over 65; the fall in median debt for this category is essentially related to paying down mortgages.

The median value of debt holdings rises across income groups, reflecting considerable borrowing to fund assets by high-income earners. Households in the top income percentiles account for the largest part of the aggregate debt. In contrast, households in the bottom one make up a very small share of aggregate debt.

Debt-servicing Burdens by Age and Income Group

In order to further assess the macroeconomic risks implied by the debt-servicing burden, it is instructive to consider different income and age categories. For example, for lower-income households, income and interest rate shocks may imply greater financial duress as they tend to have lower saving ratios and will probably also have less collateral or financial reserves. Their share in the total distribution could matter for macroeconomic outcomes.¹⁸

Table 2 - Distribution of Household Median Debt (Per Cent of Overall Per Capita Income)

Median Debt by Age

	Less than 35	35 - 44	45 - 54	55 - 64	65 - 74	75 or more
United States (2004)	114	295	281	162	85	52
Italy (2004)	95	95	76	51	32	46
Netherlands (2004)	720	741	538	453	360	405
New Zealand (2004)	126	342	281	68	7	3
Spain (2002)	300	219	137	105	57	92
Sweden (2004)	269	417	374	361	211	124

	Less than 35	35 - 44	45 - 54	55 - 64	65 or more
Germany (2003)	610	626	612	518	337
United Kingdom (2005)	81	375	226	10	34
Finland (2004)	100	316	182	88	55

	Less than 35	35 - 49	50 - 64	65 or more
Canada (2005)	257	227	119	36

Median Debt by Income

	Less than 20	20 - 40	40 - 60	60 - 80	80 - 90	90 - 100
United States (2004)	24	54	151	316	460	707
Italy (2004)	44	57	51	76	101	171
United Kingdom (2005)	38	30	113	264	263	780
Canada (2005)	26	92	256	348	416	537
Finland (2004)	34	96	210	312	292	350
Netherlands (2004)	208	542	528	640	686	686
Spain (2002)	93	107	166	207	213	384

	Less than 20	20 - 40	40 - 60	60 - 80	80 - 100
Germany (2003)	430	430	496	613	1017
New Zealand (2004)	27	39	153	284	549
Sweden (2004)	99	107	176	311	622

Source: See statistical annex.

¹⁷ Due to the lack of availability of data on income distribution, the median debt has been normalised by household disposable income at national level divided by population.

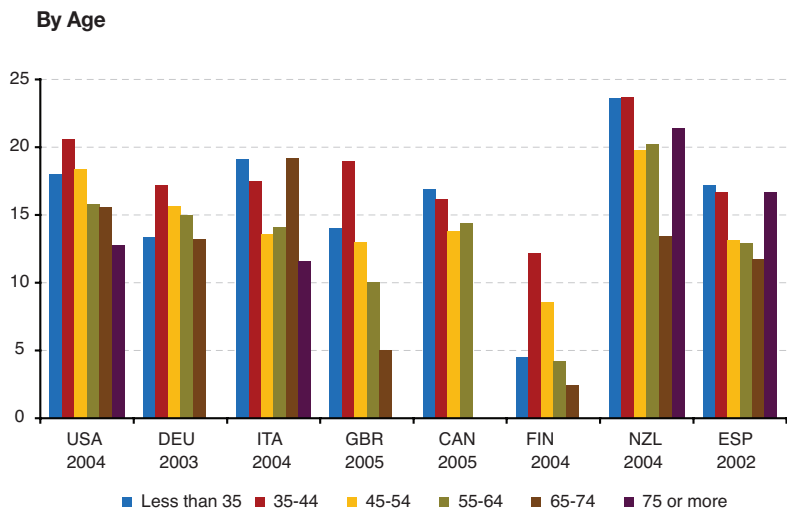
¹⁸ See for example, Herrala and Kauko (2006) who used Finnish household micro data to estimate the effect of interest rate changes (and other shocks) on household distress and bank loan losses.

HAS THE RISE IN DEBT MADE HOUSEHOLDS MORE VULNERABLE?

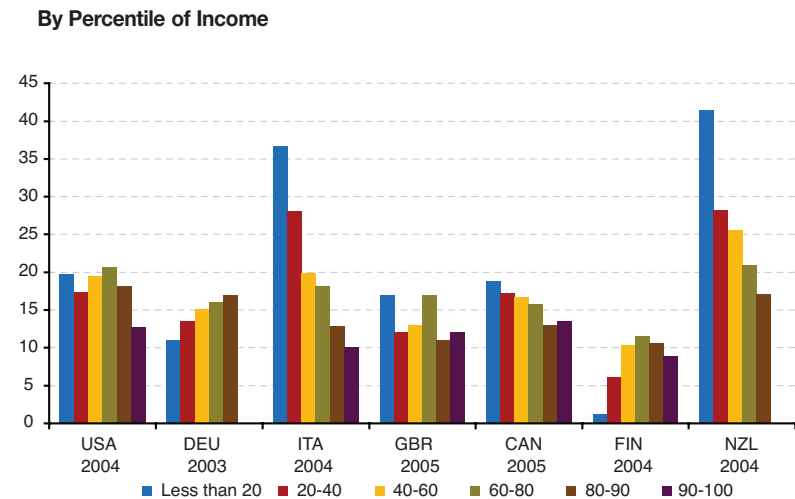
Figure 8, upper panel shows that the median debt-service ratio has been highest in the younger age groups (less than 35 and 35 to 44), likely reflecting that these households are first-time homebuyers. However, middle-age households (45 to 54), who also hold a large share of debt (Table 2), have a lower debt-service burden. Overall, for all the countries under review, households have recently devoted less than a quarter of their income to debt servicing. For the United States, for which there is information, the debt-service ratio distribution seems to have drifted up slightly for most age groups over the past decade, consistent with the trend in the aggregate data (Doms and Motika, 2006). While recent micro data for France are not available, the 2000 debt service ratio per income deciles indicated a burden roughly similar to the US profile (Bourdin, 2006).

The median debt-service burden indicator suggests that indebted households in the highest income groups are better able to service their debt (Figure 8, lower panel). They have median interest-to-income ratios close to 15% for most of the countries under review. The main exception is Finland, where the highest income households have much higher debt service burden than the lowest, but they still enjoy an interest to income ratio of less than 10%, i.e. much lower than in any other country. In Italy and New Zealand, the debt servicing ability at the bottom income groups is extremely weak; however, these households have not taken on much debt.

Figure 8 - Distribution of Debt Service Burden of Indebted Households
(Per Cent of Disposable Income)



Note: For Germany, the United Kingdom and Finland, the last age group is 65 or more. For Canada, the groups are less than 35, 35-49, 50-64 and more.



Note: For Germany and New Zealand the last group is 80-100.

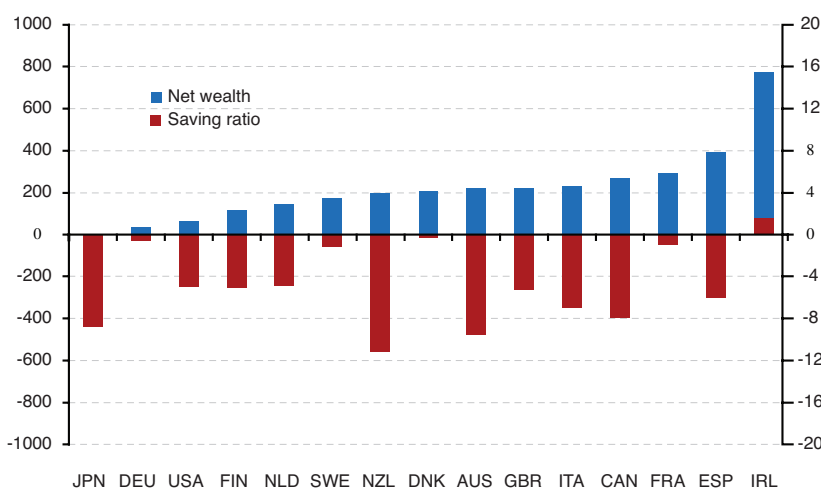
Source: See statistical annex.

Households Borrowing and Saving: Risks to the Wider Economy

Large rises in asset prices and the fall in inflation have allowed households to achieve a given level of wealth with less saving. Rising asset valuations, which households seems to view as a substitute for active savings in lifetime wealth building, have certainly contributed to the drop in the saving ratio during the 1990s. In addition, the flexibility and liquidity of mortgage markets in several countries, has helped households to rely on housing as a source of saving or investment. Figure 9 shows such a negative relationship between the changes in the saving ratio and the change in net wealth over the past decade for most countries. The main exceptions are Japan where the collapse of asset prices has kept the stock of wealth flat in relation to income and Ireland, where the strong economic performance has raised household's income and encouraged an increase in the level of savings.

The extent to which the declining trend in saving ratios can be explained by net wealth developments can be assessed using a simple econometric relationship. An equation for household saving behaviour focussing on a reduced set of explanatory variables including the net wealth-to-disposable income ratio, inflation, real interest rates and unemployment rates has been constructed. As discussed above, the wealth variable is meant to capture the extent to which households perceive asset appreciation to be a substitute for saving out of income. The effect of an increase in the real interest rate on saving is ambiguous in theory. The higher reward from saving may be offset by an income effect if net financial assets are positive. Empirical studies have tended to find mixed results (de Serres and Pelgrin, 2002) although the substitution effect seems to dominate. The inflation variable captures the precautionary saving motive in the face of higher uncertainty. Finally, a time trend has been used in some equations to capture the effects of financial deregulation and innovations which have expanded household access to borrowed money and reduced the need for precautionary saving. Annual data were used, with the estimation period ranging from 1980 to 2005, according to data availability.

Figure 9 - Changes in Saving Ratios and Wealth (1995 - 2005)
(Per Percentage Points of Disposable Income)



Note: Change over 1995-2004 for Japan, Germany, Italy, Denmark and Spain.
Source: See statistical annex.

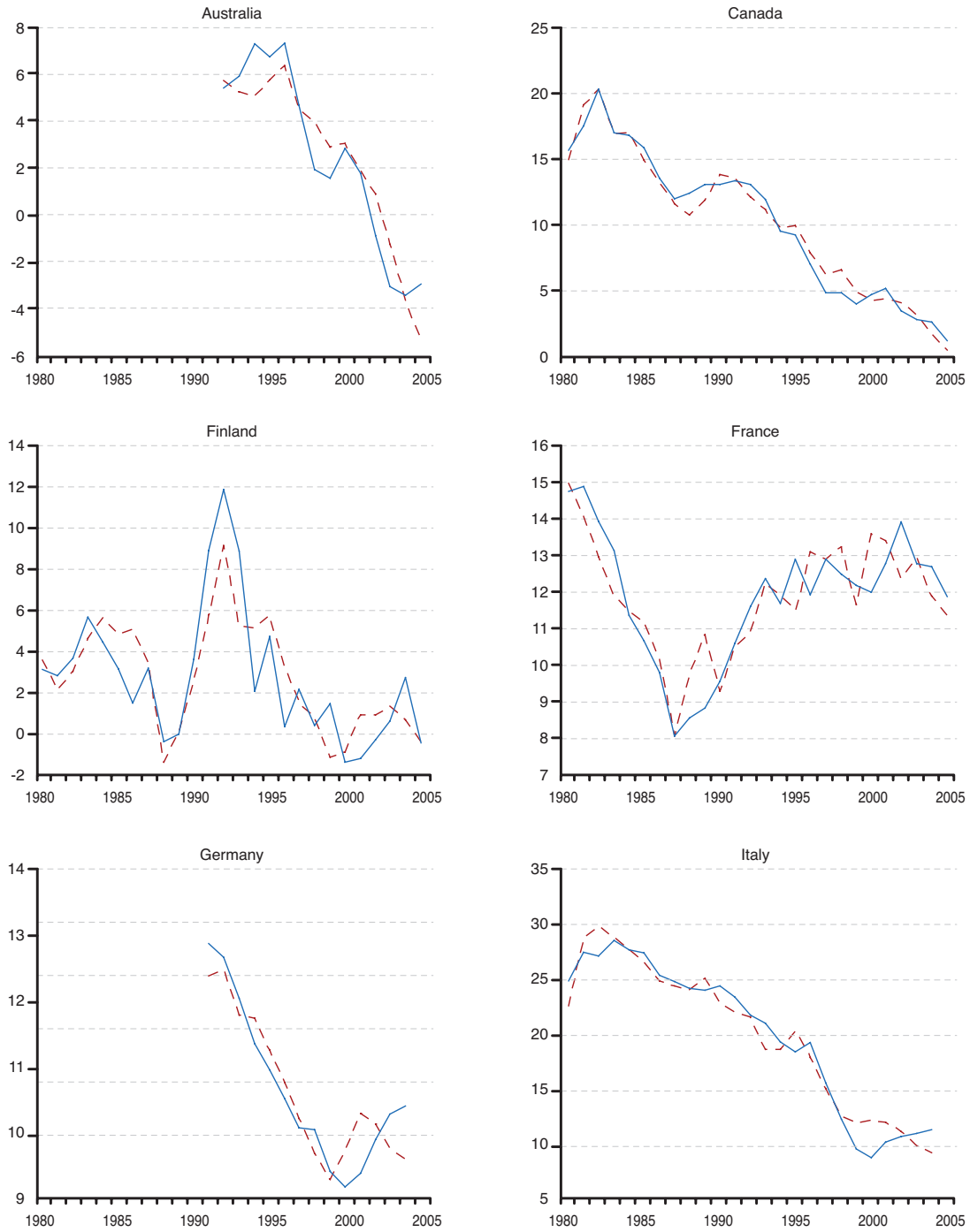
A great part of the variance of the saving ratio can be explained by the wealth-to-income ratio alone or by this ratio and a limited number of additional variables. For 12 countries out of the 15 included in the sample, a negative and significant relationship between the saving rate and household net wealth is estimated, with coefficients ranging between -0.01 and -0.06 (Table 3 - overleaf). Thus, an increase in the wealth to income ratio of 100 percentage points decreases the saving ratio by 1 to 6 percentage points. These coefficients are of similar magnitude as those reported in other studies (Catte et al., 2004; Hiebert, 2006; Klyuev and Mills, 2006; and Lansing, 2005). For Japan, Ireland, Denmark and New Zealand, it was not possible to find a long run relationship due to the lack of sufficiently long time series. The above results suggest that the long decline in saving ratio in several countries seems to be a behavioural response to the long expansions in stock and housing markets together with falling interest rates over the same period (Figure 10).

In those countries where wealth valuation effects have increasingly been used as a substitute for personal saving, a marked fall in asset values has the potential to trigger a

compensatory increase in the saving ratio, implying a slowdown in household consumption. This could have significant effects on the overall economy, given the importance of private consumption in national income, thereby also possibly adding to any strain on financial sector balance sheets. In the United States, however, the possibility of cooling asset markets and raising borrowing costs may move the saving ratio to a level which is more in line with historical averages. While such a development would act as a short-term drag on household spending and GDP growth, an increase in domestic saving would probably help correct the large imbalance that exists in the US current account.

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Figure 10 - Households Saving Ratio (Per Cent of Disposable Income)



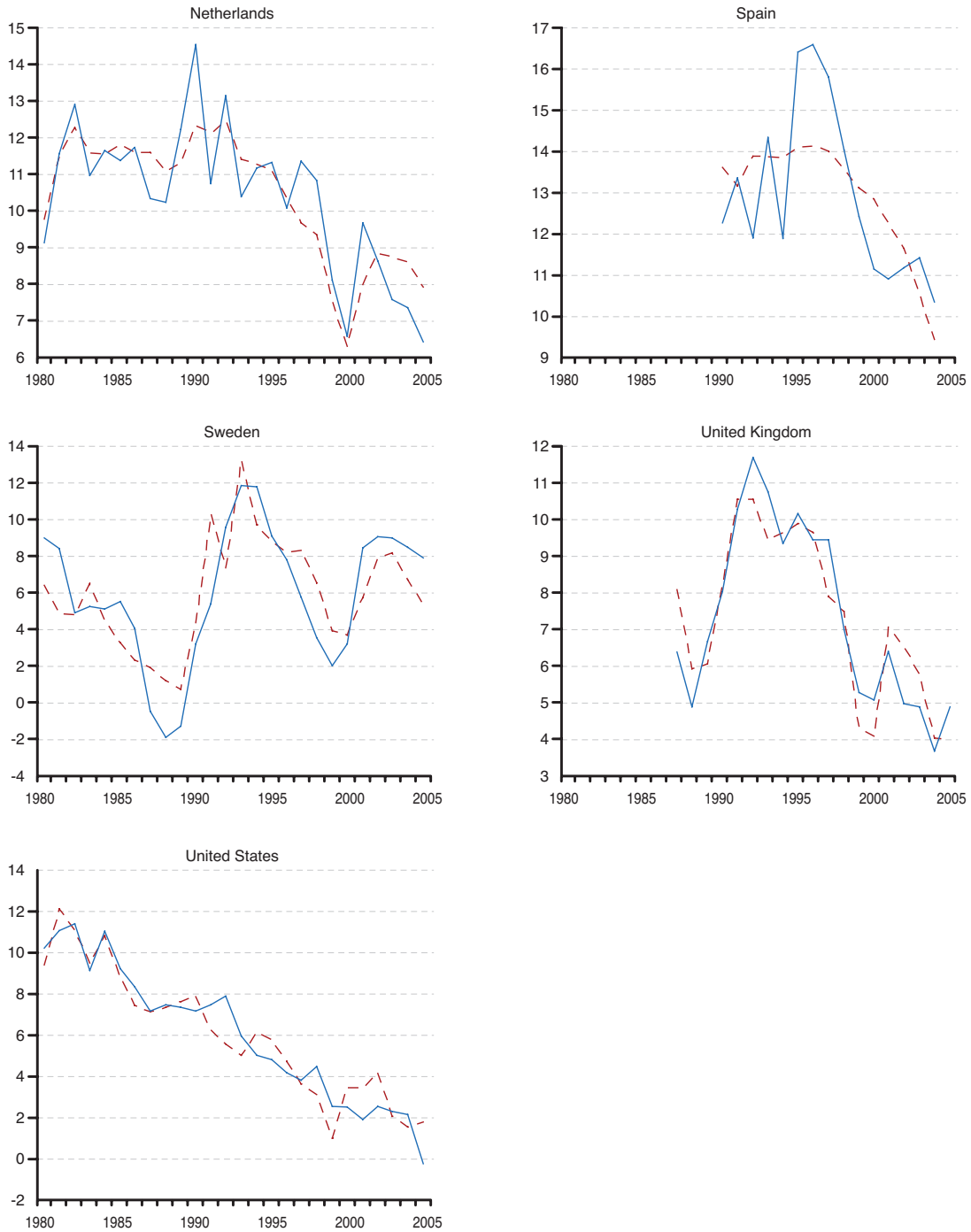
Note: The saving ratio is gross for Spain and the United Kingdom and net for other countries.

Source: OECD calculations.

— Total Leverage
 - - - Non-financial Leverage

HAS THE RISE IN DEBT MADE HOUSEHOLDS MORE VULNERABLE?

Figure 10 - Households Saving Ratio (Continued) (Per Cent of Disposable Income)



Note: The saving ratio is gross for Spain and the United Kingdom and net for other countries.

Source: OECD calculations.

— Total Leverage
 - - - Non-financial Leverage

HAS THE RISE IN DEBT MADE HOUSEHOLDS
MORE VULNERABLE?

Table 3 - Regression Results for Household Saving

	Australia	Canada	Finland	France	Germany	Italy	Netherlands	Spain	Sweden	UK	US
Net wealth (% of disposable income)	-0.05***	-0.02**	-0.05***	-0.02***	-0.05***	-0.01***	-0.04***	-0.01***	-0.06***	-0.03***	-0.04***
Real short-term interest rate		0.62***	0.51***	-0.96***							0.55***
Real long-term interest rate						1.13***			-0.79***	-0.57*	
Inflation		0.93***				0.77***					0.29**
Unemployment rate		1.02***							0.80**		
Sample	1992-2005	1980-3006	1980-2005	1980-2005	1991-2004	1980-2004	1980-2005	1990-2004	1980-2005	1987-2005	1980-2005
R ²	0.87	0.97	0.66	0.75	0.84	0.95	0.74	0.47	0.64	0.85	0.89
SE of regression	1.45	0.96	2.00	0.97	0.49	1.67	1.07	1.55	2.41	1.02	1.13

Endogenous variable: Gross saving ratio for Spain and the UK, net saving ratio for other countries.

Note: *, **, *** indicate statistical significance of coefficients at the 10%, 5%, and 1% level respectively. For Finland, France, the Netherlands and Sweden, the regression includes a time trend. Net wealth is defined as total assets minus total liabilities, inflation is measured by the change in the consumer price index, real short-term and long-term interest rates are respectively the 3-month money market rate and the 10 year government bond yield, minus the inflation rate.

Source: OECD calculations. Data sources: See statistical annex, and OECD Economic Outlook 80 database.

Statistical Annex

This statistical annex details the macro and micro data sources used for this study. There are three main differences between macro and micro data on the household sector's assets and liabilities:

- First, unincorporated businesses and non-profit institutions are included only in the macro data.
- Second, the level of detail between the two sources differs (for example, as concerns the treatment of managed accounts such as trusts and estate investment funds).
- Finally, the valuation methods for various assets and liabilities differ.

Sources for the Macroeconomic Data

Household Assets and Liabilities

Data for household assets and total liabilities (amounts outstanding at the end of the period) are based on the UN System of National

Accounts 1993 (SNA 93) and, more specifically, for European Union countries, on the corresponding European System of Accounts 1995 (ESA 95). Households include non-profit institutions serving households. Households also include self-employed persons and sole proprietors, except in the United States. Net wealth is defined as non-financial and financial assets minus liabilities.

Non-financial assets consist mainly of dwellings and land. For Germany, Italy and the United States, data also include durable goods. For Canada, France, Japan, the United Kingdom and the United States, data also include non-residential buildings and fixed assets of unincorporated enterprises and of non-profit institutions serving households, although coverage and valuation methods may differ. For Denmark, housing wealth has been estimated using the stock of dwellings at constant prices and house price data from Statistics Denmark. For Sweden, housing wealth data are from the Bank of Sweden. Net non-financial wealth is defined as financial assets minus mortgages.

Financial assets comprise currency and deposits; securities other than shares, loans, shares and other equity; insurance technical reserves; and other accounts receivable/payable. Not included are assets with regard to social security pension insurance schemes. Equities comprise shares and other equity, including quoted, unquoted and mutual fund shares. Net financial wealth is defined as financial assets minus financial liabilities excluding mortgages.

The sources for these data are:

Australia: Australian National Accounts, Financial Accounts.

Canada: Statistics Canada, Bank of Canada.

Denmark: Statistics Denmark.

Finland: Bank of Finland.

France: INSEE, Rapport sur les comptes de la nation; Banque de France.

Germany: Deutsche Bundesbank, Monthly Report and Financial accounts for Germany 1991 to 2005, Special Statistical Publication, 2006.

Ireland: Central Bank and Financial Services Authority of Ireland, Quarterly Bulletin, No. 3, 2006.

Italy: Banca d'Italia, Supplements to the Statistical Bulletin; Ando, A., L. Guiso and Financial Accounts of OECD countries.

Japan: Cabinet Office, Government of Japan, Annual Report on National Accounts.

New Zealand: Reserve Bank of New Zealand.

UK: Office for National Statistics, United Kingdom, National Accounts and Financial Statistics.

US: Federal Reserve Statistics Release, Flow of Funds Accounts of the United States.

Spain: Bank of Spain.

Sweden: Bank of Sweden and Statistics Sweden.

Mortgage debt data for non G-7 countries have been estimated using various national sources and are not necessarily fully consistent with SNA 93 and ESA 95. For Australia, mortgages refer to outstanding loans to households for housing by type of lending institution in the Financial Accounts of the Australian National Accounts. For Denmark, mortgages are from Statistics Denmark and refer to lending of mortgage banks by sector. For Finland, mortgage data are from the Bank of Finland. For Ireland, data are from the Central Bank and Financial Services Authority of Ireland 2006 Quarterly Bulletin No. 3, (see Kelly, 2006). For New Zealand, data are from the Reserve Bank of New Zealand. For Spain, data are from the Bank of Spain and for Sweden, from Statistics Sweden.

GDP and Disposable Income

GDP and household disposable income are taken from the OECD Economic Outlook 80 database.

Share of Adjustable Rate Loans in Housing Loans

The 2005 data for the share of new loans in housing loans are defined as loans with a duration of one year or less. For most European countries, the data are from European Mortgage Federation (2006). For France, the data are from Gouteroux (2006). For Italy, data are from the Bank of Italy. For Finland, they are from the Bank of Finland. For Japan and Canada, they refer to the Bank of International Settlements (BIS) (2006) and correspond to adjustable rate loans with a duration up to five years. For New Zealand, data are from the Reserve Bank of New Zealand. For Australia, the data come from the Reserve Bank of Australia. For Ireland, data are from Central Bank and Financial Services Authority of Ireland (2006).

The data for the share of outstanding loans are defined as loans with a duration of one year or less. They are taken from Girouard et al. (2005) for Australia, Canada and France. For most European countries, the data are from European Mortgage Federation (2006). For Japan, data are from the BIS (2006). Other, country-specific sources are: Bank of Italy (2006), Bank of Finland and the Reserve Bank of New Zealand.

Sources for Mortgage Delinquency Rates

Australia: Bank on-balance sheet housing loan arrears 90+ days, Reserve Bank of Australia.

Canada: Residential mortgage loans in arrears three months or more, Canadian Bankers' Association and Statistics Canada.

France: "Part des encours douteux, Enquête auprès des principaux établissements distributeurs de prêts à l'habitat", Banque de France.

Finland: Non-performing assets of households, Bank of Finland.

Italy: New bad debts during the year as a percentage of outstanding loans, Bank of Italy.

Spain: Household non-performing loans (for house purchase), Bank of Spain.

UK: Mortgage arrears for more than three months, Council of Mortgage Lenders.

US: Delinquency rate on single-family residential mortgages, booked in domestic offices; all commercial banks (seasonally adjusted), Federal Reserve Board.

Sources for the Proportion of Households Holding Debt

The "other debt" category is generally defined as unsecured debt in the form of personal loan, overdraft, credit card, store card, student loan, social fund loan and other loan.

Spain and Ireland: ECB (2005).

Canada: The data, provided by the Bank of Canada, are based on the Canadian Financial Monitor (CFM), a survey conducted by Ipsos Reid Canada. Data are for 2005. For more detail, see Faruqui (2006).

France: Banque de France (2005).

Finland: Bank of Finland (2006).

Germany: Federal Statistical Office.

Italy: Banca d'Italia (2006b).

US: Bucks et al. (2006).

UK: May et al. (2004).

Sweden: Bank of Sweden

New Zealand: Treasury of New Zealand. For information, the proportion of households holding "other debt" excluding student loans is 69.4% and the proportion of households holding "other debt" excluding credit cards is 48.3%.

Sources for the Micro Data

Australia

No micro data were provided for the study. There are, however, two household micro surveys which are of interest, the Household Expenditure Survey (HES) conducted by the Australian Bureau of Statistics and the Survey of Household and Income and Labour Dynamics (HILDA), which is administered by the Melbourne Institute. The aggregate results from the HES are available at: [http://www.abs.gov.au/AUSSTATS/abs@.nsf/Lookup/6530.0 Main+Features12003-04%20\(Reissue\)?OpenDocument](http://www.abs.gov.au/AUSSTATS/abs@.nsf/Lookup/6530.0>Main+Features12003-04%20(Reissue)?OpenDocument). The information on HILDA is available at <http://melbourneinstitute.com/hilda/>. For more detail, see Kohler et al. (2004).

Canada

The data, provided by the Bank of Canada, are based on the Canadian Financial Monitor (CFM), a survey conducted by Ipsos Reid Canada. Data are for 2005. For more detail, see Faruqi (2006).

Denmark

No micro data were provided for the study. However, households' indebtedness is discussed in Danmarks Nationalbank (2006).

European Union countries

The European Central Bank (ECB) provided some data from the 2001 European Community Household Panel database. They are reported in part in ECB (2005).

Finland

Data for 2004 are from the Bank of Finland (2006).

France

No micro data were available for the study. However, the Banque de France has produced several studies on household indebtedness, see for instance Banque de France (2005) and Boutillier et al. (2005). See also the work from the Commissions du surendettement at: <http://www.banque-france.fr/fr/instit/services/page3a.htm>. Selected micro data are reported for 2005 in Moullart (2006).

Germany

The data, provided by the Federal Statistical Office, are based on the Income and

Expenditure Survey 2003. For more details, see Bartzsch and Stöss (2006).

Italy

The data, provided by the Bank of Italy, are based on the 2004 Survey of Household Income and Wealth (SHIW), Banca d'Italia (2006a and b). For details on the previous surveys, see <http://www.bancaditalia.it/statistiche>.

Netherlands

The data, provided by the Nederlandsche Bank, are based on preliminary results of the 2004 regular Dutch DNB Household Survey (DHS). For details see Van Els et al. (2003) and De Nederlandsche Bank (2005).

New Zealand

The data, provided by the Treasury of New Zealand, are based on the survey SoFIE for 2004, see <http://www.stats.govt.nz/additional-information/survey-of-family-income-employment/default.htm>.

Spain

The data, provided by the Bank of Spain, are based on the 2002 Survey of Household Finances (EFF). For more detail see Barcelo (2006), Banco de Espana (2005), Bower et al. (2005) and Bover (2004).

Sweden

The data were provided by the Bank of Sweden and Statistics Sweden. An analytical exposé of the Bank of Sweden uses of micro data can be found in Johansson and Persson (2006).

UK

The data were provided by the Bank of England and are based on 2005 NMG Research survey and on the Bank's calculations. For more information, see Barwell et al. (2006). For details on the 2004 survey, see May et al. (2004).

US

The data are from the Federal Reserve Bank and are based on the 2004 Survey of Consumer Finances. They are reported in Bucks et al. (2006). For references to earlier surveys, see Aizcorbe et al. (2003).

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Housing Finance in Afghanistan: Opportunities and Risks

by Garth Bedford¹

This article is intended to circulate the results of the Afghanistan Housing Sector Assessment Workshop held by the International Financial Corporation (IFC) in March 2007. The workshop was held to disseminate the results of the Afghan Housing Sector Assessment completed for the IFC and the World Bank.²

Background

Twenty-six years of almost continuous warfare has left Afghanistan in the bottom six of 177 countries in the human development index, an economy based on narcotics and donor money, and with a legacy of ineffective and competing governments that forced nearly six million refugees to flee Afghanistan into Pakistan, Iran and other nations. Many have returned to find housing infrastructure that has been badly damaged by war and repeated earthquakes, their land legally appropriated by others during successive governments or illegally grabbed by powerful elements. The large increase in population coupled with insufficient housing has resulted in a large amount of illegal and overcrowded housing as people desperately search for shelter. The problem will continue to worsen as more refugees return to find their homes either destroyed or occupied by others with legal title. This will be especially severe in urban areas. According to UN estimates, from 2000 to 2015, the national population is expected to increase by 14 million to reach a total of about 37 million; more than half of this growth will be in urban areas where the housing deficit is most severe. Although accurate figures are not available, the Minister of Urban Development estimates there is a current need of one million new housing units in Afghanistan, with 70% of this deficit in urban areas.

Due to the severity of the problem of insufficient and dilapidated housing stock coupled with the population explosion and rapid urbanisation the Afghan government is under a great deal of pressure to provide appropriate housing solutions to the population. At this point Afghanistan has taken steps to overcome the housing shortage in the country, and this has led to some successes. The successes cannot take hold however until private enterprise steps in and begins offering housing finance. Unfortunately, the overall situation is still too tenuous for financial institutions to begin large-scale lending in the housing market. Several ministries, donors and the Central Bank are all working on aspects of the sector that will help overcome some of the obstacles, although with varying degrees of coordination.

Current State of Housing Finance

There is an enormous gap in the supply vs demand of housing finance in Afghanistan. The housing finance industry in Afghanistan is in its infancy and there is no more than token levels of housing finance available, whether formal or informal. Currently transactions are funded on a cash basis, which precludes all but the wealthy from participating in the market. Two state-owned banks, Millie Bank and Pashtun Bank, have made small forays into the housing finance market. Reports state that other banks currently provide funds for the purchase of a home. These are not traditional mortgages since they are structured as an Islamic compliant lease buy-back structure known as *Murabaha* (in which the bank holds the title and effectively leases the house to the buyer); these loans are made exclusively on a relationship basis. On the housing microfinance side, only

one microfinance institution (MFI) has extended loans to approximately 100 slum dwellers for home improvements.

Despite the demand in the market, most financial institutions do not feel the environment is compatible with housing finance and focus mainly on loans for commercial activity. They are not at all confident in their ability to establish clear title for the property; the lien mechanism is too expensive and lengthy to implement; there are no secured transaction or foreclosure laws; no long-term funding is available; no homeowners insurance is available; and, these institutions lack professionals versed in mortgage products and methodology.

Lack of Expertise

In Afghanistan there is a severe lack of a professional class, which has affected all areas of the economy, including the housing market. This has led to a lack of confidence and transparency in the property market and title searches as well as a reticence for institutions to enter a market their staff do not have any knowledge of.

Within Afghanistan there are few people with the skills to conduct a proper title search and declare title free and clear, and even these qualified individuals are not willing to guarantee the result. Unfortunately those few who are qualified to execute such a title search are mainly in Kabul and are vastly outnumbered by those who are unqualified and possibly engaged in fraudulent activities. A lack of transparency or enforcement in the title system fosters an environment for corruption that the banks are not willing to face.

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² The Study was conducted by ShoreBank International and CHF. The views in the paper are solely the responsibility of the author, and do not necessarily reflect the views of IFC, Worldbank, ShoreBank International or CHF.

Similar to the lack of professionalism and training in the title sector, there is also no capacity in appraisal leaving banks unable to rely on the valuation of the property. Property dealers pay a small amount to the Ministry of Justice and are able to obtain a real estate licence, with no exam or other verification of credentials. The property dealers are the same people who are then valuing houses for banks. These same property dealers are also often involved in title verification. With no code of conduct or training, banks are unable to have confidence in either their verification of value or title.

Due to a lack of transparency in the sector it is difficult to deduce the real sales value of houses in Afghanistan, and thus develop a set of comparable values for any property a bank might lend on.

Within the country there are no knowledgeable practitioners of mortgage or housing finance. This has left the financial institutions without the knowledge on how to develop housing finance products and mortgage departments. Due to this knowledge gap most institutions are unwilling to move into a product line they are unsure of.

It will become necessary to upgrade the capacity, professionalism and oversight of all those involved in the housing market to ensure the long term success of housing finance.

Land Insecurity

Lack of confidence in the title held by homeowners is perhaps the major obstacle for financial institutions for not entering the housing market. Afghanistan has been subject to several traditional means of property transfer along with various official and conflicting registry schemes implemented over the preceding decades.

Over the past 25 years, various governments and officials have used land as a tool to prop up their regimes. Communists appropriated land, Mujaheddin appropriated the same land

and distributed it to their supporters, and this was then taken by force by Taliban commanders and distributed once again. Unfortunately the occupation and illegal appropriation continues to this day. During each transfer, legal or not, a legal title was issued by a complicit land office and court system using forged title deeds. In addition, squatters who have moved onto land, either government or private, built a home while the owners were abroad during the conflicts. Thus many refugees have returned to discover that, despite holding legal title, others with equally legal title are already in their homes, and there are often still others who hold claim to the property.

Due to the cost and difficulty in obtaining official title, many people prefer to rely on alternative ownership documents which may date back many generations. In Kabul alone it is estimated that 70% of the population is residing in property which has not been formally registered. Although they may legitimately be entitled to the land, they risk being evicted by others who might acquire a more legal title.

Even prior to the wars land title has been complicated in Afghanistan due to several legal regimes that have been in place:

1. Customary law (*rawaj*),
2. Civil law (*qanoon madani*),
3. Religious law (*Shar'ia*)
4. Statutory or national state law

Much of the Shar'ia law is enshrined in the civil law, which often differs from customary law, yet all are applicable where state law does not apply. Frequent regime change has also led to over 60 different land laws and amendments in the state law³.

Thus, property may legally be held in a number of different manners, some of which do not include formal registration with the municipality, but instead a customary document attested by the local Shura or Jirga⁴. Although Shuras and Jirgas are not officially recognized by the court system, it is often the most effective way to conclude a transaction or resolve a land

dispute - however, very often with a strong tribal or gender bias.

Insecurity has also left developers with a need to keep a large fund of money (as a reserve) to pay off all individuals claiming title on land on which they are building. This includes land sold to them by the city with a guarantee of clear title. This reserve fund is nearly the same amount as the developers have to pay for the land. Developers who do not intimately know the market and do not have good government contacts are reticent to enter the market in large part due to this issue. They are rightly worried about building a complex and finding out they do not in fact hold a clear title.

The cost of paying off all valid and dubious claims to property is one of the concerns about finalizing the title to all property. Insofar as there may be several valid claims to the same property, and only one claimant will be able to receive the ultimate title, the other valid title holders will need to be compensated. How much and by whom is a question nobody is willing to face at this point. Yet all agree the issue must be resolved as soon as possible.

Difficulty in the Creation of Liens

Currently it takes several months and costs six per cent of the property value in order to register a lien. During the several-months-long process, one or other of the parties will be subject to a large amount of risk. The seller will either have to transfer the title to the buyer before being paid in order for the bank to register the lien, or the bank will have to pay the seller, then take a risk of the collateral being lost before the lien is perfected. Alternatively, the borrower will have to pay cash for the property and then take out a mortgage after the lien is registered. As currently there is no escrow regime, there is no alternative for the money to be held by a third party, contingent on the lien being registered. The prohibitive cost and timings have kept a majority of people from properly perfecting a lien, generally preferring informal contracts.

³ AREU shaping urban futures, March 2005.

⁴ Shura and Jirga are interchangeable terms for traditional decision making assemblies at the village, district, provincial and national levels, the former a Persian/Dari term and the latter a Pashtu term. At a village or community level they are customarily made up of elders with informal, yet binding, dispute resolution and decision making powers. They balance the power of the local community and central state power and have been a venerable hallmark of Afghan political reality.

Lack of Legislative and Legal Environment

Currently there is no mortgage, securitisation or foreclosure law under which the banks would function. In the case of delinquency or default there are no clear options available to the financial institution in order to acquire and dispose of the collateral, even in the case where a valid lien is perfected against the property.

Under Shar'ia law, which encompasses much of the property law used by the courts, it would appear very difficult to foreclose on and evict occupants of a property that is the sole shelter for a borrower. Thus, many of the banks that are using property as collateral ensure that the borrower has other property he can reside in, and the institution effects a lien against the second home. Of course this is not practical for the vast majority of Afghans, but it remains the only means a bank can use to solidify its claim in case of default.

Currently several laws are under consideration to overcome these legal hurdles. The USAID funded Emerging Markets Group has introduced a Secured Transaction law for Immovable Property, effectively a Mortgage Law, with the Central Bank (Da Afghanistan Bank). This is currently being reviewed by the Ministry of Justice for presentation to the Parliament.

Lack of Trained Judiciary and Enforcement

As with many areas of the Afghan legal system, the judiciary are poorly versed in the area of property law. This is unfortunately an area which is very slow to be addressed.

While there is now a property tribunal set up in Kabul to examine property issues throughout Afghanistan the results have been very poor to this point, and at a provincial level this court has had little or no impact on the way disputes are settled, which is usually through tribal or informal means. These informal and tribal means work well if you are a member of the same ethnic group, tribe or male, but less so if you are a minority or female. Consequently the provincial authorities have had mixed success in resolving land disputes. Although it has been possible to resolve disputes where no leverage

can be influenced, in cases in which one participant has political or other influence, the result is often biased⁵.

Overall, due to the perceived and real lack of effectiveness of the formal judicial system as well as the time that is required to get a case heard, most disputes are heard outside of the formal system, despite the various levels of influence brought to bear on the informal resolution structure. There is interaction between the formal and informal dispute resolution mechanisms, and the Afghan civil code does recognize mediation and arbitration as legal forms of dispute resolution.

The USAID Rule of Law Program is currently implementing a training program for jurists which will include a section on property law. Although this will not be as comprehensive as needed, it will provide a basis for future capacity building.

As great a threat as the absence of a viable property court is the lack of any enforcement of edicts that are made. The authorities are theoretically responsible for carrying out property related judgements, but they are poorly trained and equipped and thus unwilling to involve themselves in property issues. This lack of follow-through undermines the legitimacy and authority of the court and often leaves claimants in the same position as they were before the judgement, thus forcing them to rely on informal means for resolution.

It is unfortunate that the application of property law usually takes place through informal settlements. In disputed areas the situation is even more problematic due to the lack of any anti-eviction laws that create insecurity amongst the inhabitants who can be removed at any time without legal recourse.

Lack of Cadastre

Lack of clear boundaries has led to many, sometimes fatal, land disputes. The years of conflict have hampered the implementation of modern mapping techniques, which could have resolved these disputes. Few properties have been properly surveyed and most customary deeds offer only vaguely defined

boundaries. These are often described as abutting someone else's land which itself is not surveyed.

The Afghan Geodesy and Cartography Head Office (AGCHO), has begun digitizing existing cadastral maps, but these are only a small portion of the estimated 800,000 properties in the country.

If there is going to be any finality in the issuance of final title to land in Afghanistan, there is a need to be an accompanying clarification on cadastre.

Difficulty in the Transfer of Title

Due to the high cost, corruption and the lengthy process most property owners have not used the formal land titling process, but have instead relied on traditional means of registering their ownership. To overcome this, the Afghan Supreme Court recently took action to bring people into the formal land titling regime. The steps involved in the titling process have been reduced from more than 30 to just four or five.

However, as before, each step involves a large amount of time and considerable cost. As a result, many people continue to avoid formal registration in favour of traditional means of declaring ownership.

Without a simplified and cost-effective means to transfer property on the formal market, people will continue to accomplish this informally, which will further fragment the titling framework. The recent moves to simplify the process is expected to lead to more transparency in the secondary property market (currently it is difficult to determine the sales price of any home). The eight per cent transfer fee, however, will continue to hinder the attempt to formalize the sector. The Parliament is currently reviewing the possibility of lowering this tax to two per cent.

Lack of Funding Resources

Afghanistan, as in many developing countries, has an excess of liquidity in the banking system. These funds though are generally in the form of short-term deposits, which do not

⁵ UNHCR, Land Issues within the Repatriation Process of Afghan Refugees - 2003

match the longer-term funding needs of housing finance. Afghanistan has a higher amount of inherent risk than most countries which makes it even more unlikely that financial institutions will lend long term without some form of guarantee or risk sharing.

In the Afghan banking sector where 48 months is considered a long-term loan and 20% is a marginal interest rate, banks will need to access other funding or guarantee sources to develop a housing finance product that will be of value to the average Afghan.

Lack of Insurance

In Afghanistan, it appears that insurers do not offer life and property insurance. Another concern for lenders is protection against fire and earthquake that is of a particular importance for Kabul and the surrounding region. Currently the sole insurance company in Afghanistan, the Afghan National Insurance Company, is nearly non-functional, both undercapitalized and in poor financial condition. Although the insurance law has been revised, it has not been enough to incite insurance companies to enter the Afghan market. Without insurance, the risk may be too high for banks to lend to homeowners.

Unfortunately even if insurance were available, due to the highly risky nature of Afghanistan, both natural disasters as well as man-made disasters would result in premiums that would not be affordable for most Afghans.

Prognosis

While there is clearly much work to be done Afghanistan has made remarkable progress in the years since the current government has come to power. The economy has been growing at a rate of 17% per year, per capita income has nearly doubled, children are returning to school and rebuilding is visible in most areas. Without access to suitable housing, and the jobs that the housing industry creates, it will be difficult for the population to fully benefit from the successes.

Even as the government and donors continue to make headway on updating legislation to enable the development of the housing market, attention needs to be paid to supporting those

institutions willing to begin work in this market. Areas of assistance would consist of capacity building and supply of mechanisms to improve the funding structure of lenders.

A most likely first step in the housing finance market will be the entry of MFIs that will be able to enter the market without the same requirements as banks. The demand is understood to be the largest in the sector where MFIs operate; in view of their specific lending technology they would not require the placement of liens or in some cases the use of collateral. Although only one MFI is currently offering a housing product, several are preparing to enter the market.

Initial studies have shown a large demand for loans of under \$5,000 for home upgrade and between \$5-10,000 for new home construction. A survey undertaken by the MFI Finca Afghanistan in their Jalalabad office indicated that members of their borrowing groups would need \$1,000 for upgrade and \$6,000 for construction while individual clients would require \$2,000 for upgrade and \$10,000 for construction. This size loan could be offered without perfecting a lien, and using alternative collateral or none at all.

Most MFIs also acknowledge that a portion of their business loans are used for home improvement without their knowledge, although clients are often reluctant to admit they have used their loan proceeds for purposes other than the stated use.

Currently several MFIs are serious about housing microfinance but they all face similar hurdles to the roll-out of a housing product in any scale: funding and lack of capacity. To promote immediate activity in the housing finance sector any assistance would be recommended to focus on these two issues in order to support MFI-entry into the sector. If these two issues could be overcome MFIs were likely to begin operations in the housing sector.

To incite financial institutions to enter the market, all or a majority of the identified issues must be addressed. During the conference some banks stated their willingness to begin operations if given support in building their internal capacity. The majority, however, indicated that they need to see a much

improved enabling environment for them to enter the mortgage market.

It would be recommended to take on the following points in order for institutions to support mortgage lending in the country:

- A final decision must be made as to the legal holder of all property titles, and compensation conferred to those who have lost their land.
- The land titling and registrations system must be improved. Title deeds must be standardised, formalised, and the transfer of title must be simplified and the cost reduced.
- Creation and perfection of a lien must be simplified and the cost must be cut. This would include an accompanying clarification of the cadastre.
- The mortgage law and statutes to strengthen property rights must be enacted and the judiciary trained in property law to uphold the rights of all parties.
- Improved lien enforcement must be put into place and those responsible should be given the tools to carry out property related judgements.
- It will become necessary to upgrade the capacity, professionalism and oversight of all those involved in the housing market to ensure the long term success of housing finance. This includes title search, appraisal, and property dealers as well as upgrading the capacity of the financial institutions.
- Support the creation of a property insurance industry, or provide alternative guarantees.
- Structure a funding or guarantee mechanism providing financial institutions with an incentive to enter the market.

When it can be shown that this is a profitable market and institutions begin offering housing products, the population may finally have the opportunity to live in acceptable housing. Until that time, the lack of adequate housing will continue to be a source of instability in Afghanistan.

Recent Experiences in the Housing Finance Sector - A Study with Reference to India

by Dr.P.Saravanan,
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Housing is one of the fundamental demands for living. Access to acceptable housing is one among the elementary human needs as well as one of the keys to peace and happiness. In every country, resolving housing issues has political, social and economic significance. Housing is a significant engine for growth and development of the economy. Home to roughly 1.1 billion people, India is the second most populous country after China and is expected to overtake it by 2030; roughly one in every sixth person on earth lives in India.

The growth rate of the population is still rapid which will result in an unfavourable land-man ratio reflecting high density in pockets. The

disproportionate urbanization leads to steady migration of people from rural to urban areas at the aggregate level. This in turn resulted in a huge demand on the infrastructure of the cities, besides causing pressure on the land.

It is evident from Table 1 that one in every three Indians is under the age of 15, and only one in three is older than 35. When comparing with other countries such as China, USA and Japan, India has the unique advantage of a higher level of middle aged and lower level of aged people. Indian GDP has grown at 6% for the past 10 years and 8% for the last three years and interestingly the service sector accounts for 60% of GDP.

It can be seen from the Table 2 that in spite of the merits highlighted in the preceding paragraphs, India has the lowest figure for house mortgages as a percentage of GDP. Amongst the Asian countries, Hong Kong has the highest ratio, followed by Taiwan, Malaysia, Thailand and Korea.

Table 1 - Population and Age wise Analysis of Selected Countries

Age Group	India	China	US	Japan
0 - 14	32%	23%	21%	14%
15 - 29	28%	24%	21%	19%
30 - 44	20%	25%	22%	20%
45 - 64	15%	20%	24%	28%
Above 65	5%	8%	12%	19%
Population (million)	1,066	1,291	290	127

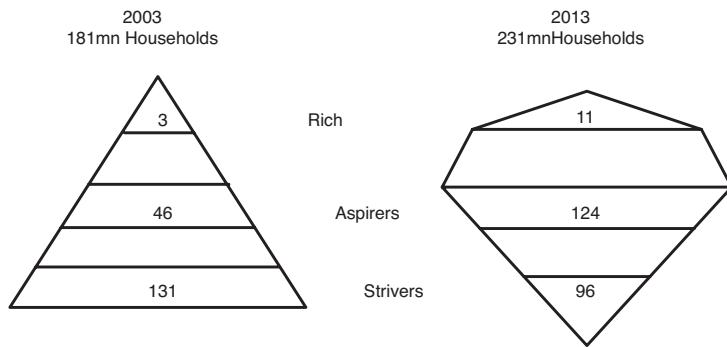
Source: Mckinsey Report 2005

Table 2 - House Mortgages as a Percentage of GDP

Country	Percentage of GDP as House Mortgages
India	4%
Korea	14%
Thailand	18%
Malaysia	23%
Taiwan	37%
Hong Kong	60%
Germany	52%
Singapore	68%
USA	86%
UK	72%
Denmark	90%

Source: Economy watch report, 2006

Exhibit 1 - Rising Consumption Pattern in India



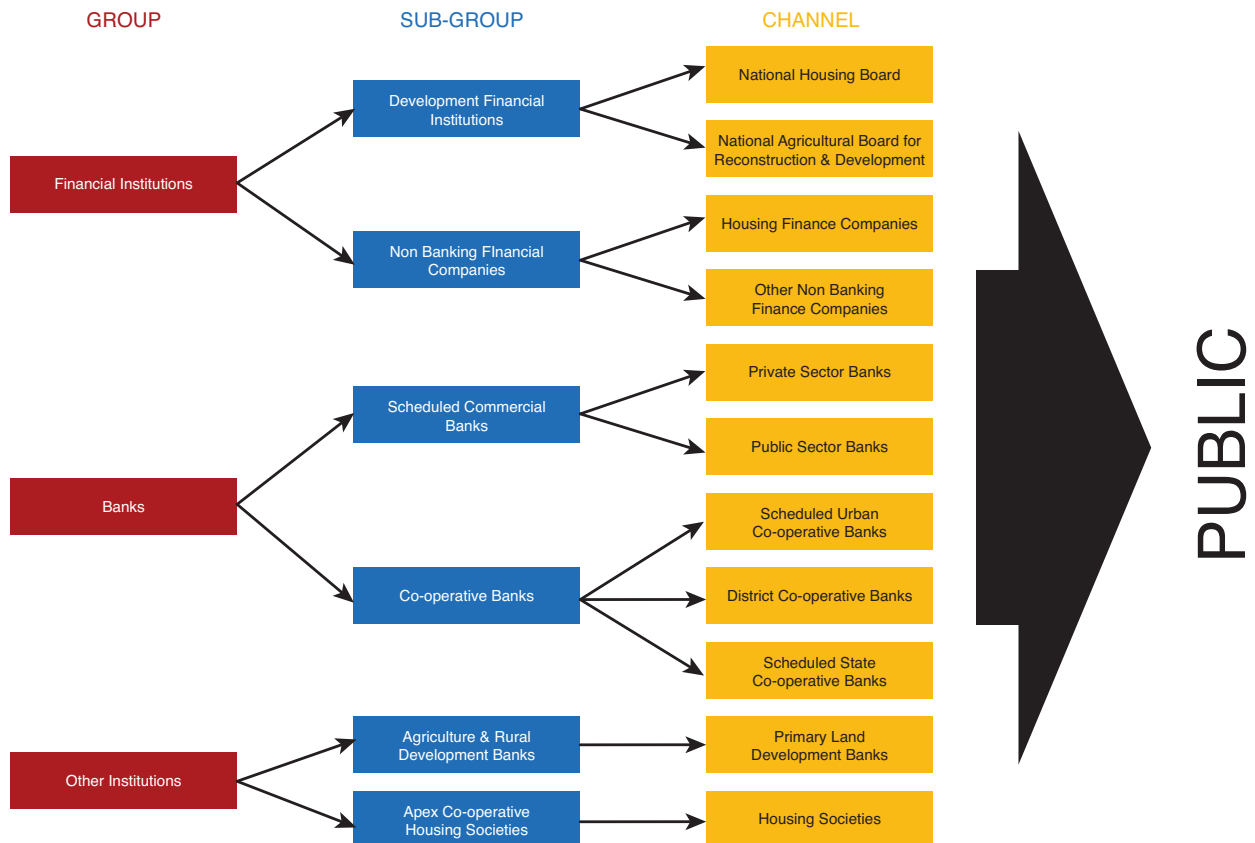
It could be inferred from Exhibit 1 that the consumption pattern amongst the Indian population is expected to change 2013. The strivers are less but aspirers and rich are significant higher compared to 2003. The housing finance sector in India has undergone unprecedented change over the past two decades. Exhibit No 2 depicts clearly the existing housing finance system and Exhibit No 3 indicates the transitions.

The housing finance requirements in the country are catered for by the following types of institutions:

- Scheduled Commercial Banks
- Scheduled Cooperative Banks
- Regional Rural Banks
- Agriculture and Rural Development Banks
- Housing Finance Companies
- State Level Apex Co-operative Housing Finance Societies

Source: NCAER 2005

Exhibit 2 - Housing Finance System in India*



*Adapted from NHB Report, 2006

Housing finance as a financial service is relatively young in India. The growth in housing and housing finance activities in recent years reflect the buoyant state of the housing finance market in India. The real estate sector is the second largest employment generator in the country.

The government's support to housing had traditionally been centralised and directed through the State Housing Boards and Development Authorities. In 1970, the state set up the Housing and Urban Development Corporation (HUDCO) to finance housing and urban infrastructure activities. In 1977, the Housing Development Finance Corporation (HDFC) was the first housing finance company in the private sector to be set up in India. The public sector insurance companies - Life Insurance Corporation of India (LIC) and General Insurance Corporation of India (GIC) were also mandated to support housing finance activities, both directly through their housing subsidiaries (both established in 1989) and indirectly through a mandated requirement to invest a certain proportion of their annual accretion in socially oriented schemes which includes housing.

In 1988, the National Housing Bank (NHB) was established as a 100% subsidiary of the Reserve Bank of India, (the central bank of the

country), to promote housing finance through a refinance mechanism to banks, housing finance companies (HFCs) and other institutions and also to function as the supervisory and regulatory body for housing finance firms.

Currently there are 29 HFCs approved for refinance assistance from NHB. Although commercial banks were the largest mobiliser of savings in the country, traditionally banks were rather reluctant to lend for housing as they preferred financing the working capital needs of the industry. Several banks had set up housing finance subsidiaries which functioned as independent units with little support or interest from their parent bank. Towards the end of the 1990s, against the backdrop of lower interest rates, industrial slowdown, sluggish credit off-take and ample liquidity, and financial deregulation commercial banks shifted their focus from the wholesale segment to retail portfolios.

Growth Trends

The lower interest rate regime, rising disposable incomes, stable property prices and fiscal incentives made housing finance attractive business for commercial banks. Further, housing finance traditionally has been characterised by low nonperforming assets

(NPAs) and given the vast demand for housing loans, almost all the major commercial banks plunged into the business of housing finance. The robust growth during the last decade has been triggered by a number of factors, some of which are listed below:

- Tax rebates on housing loans announced consistently in the annual budgets of the country.
- Falling interest rates on home loans: Fixed interest rates calculated on an annual rest basis for a loan of Rs.1 million for tenure of 15 years have fallen from 16% in 1997-98 to 9.5% in 2005-06. Floating rates for short maturity housing loans are today hovering in the range of 7.75-9.75%.
- Greater amount of professionalism of the real estate developers and builders who are capable of acquiring clearer titles and completing the projects on time.
- Borrowers can raise up to 100 % of even 110% (in which case the lenders provide financial assistance for the complete property value, stamp duty, registration and an additional 10% is given for the interior decorations) of their borrowing requirement from the lenders.

Types of Housing Loans:

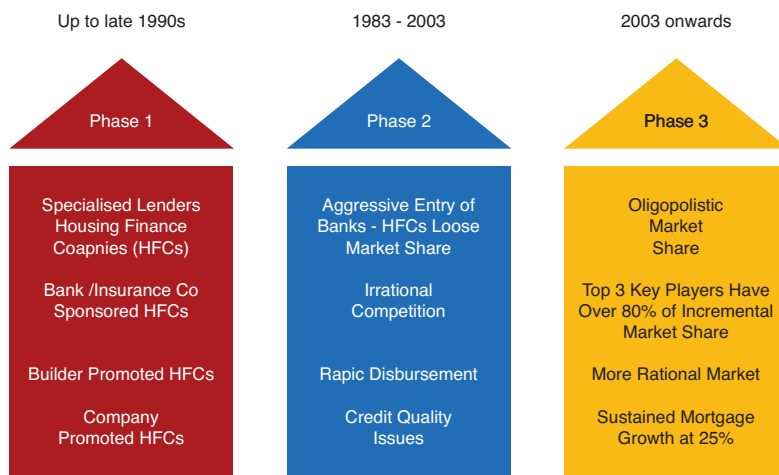
The following types of home loans are generally available in the market:

Home Equity Loans: A form of finance to the customer by way of mortgage of existing property to the financier for taking a loan for some other purpose. The current market value of the property is the basis for providing home equity loans.

Home Extension Loans: The purpose of this loan is the extension of existing houses like the addition of rooms, toilet facilities etc. Such loans fall under the category of home loans.

Home Improvement Loans: These loans are provided mainly for repairs and maintenance of existing houses. These could include internal and external repairing, waterproofing and roofing, complete interior renovation, tiling and flooring etc.

Exhibit 3 - Housing Finance Market in India



Source: Adopted from Pareh, D (2006)

Home Purchase Loans: Finance provided for the purchase of ready-made houses.

Land Purchase Loans: These loans are being provided for the purchase of land for the purpose of construction of residential houses.

The loan amount generally depends on the period for which the loan is needed and the repayment capacity of the borrower. The amount of the loan is also subject to the estimated value of property and clear title deeds of the borrower. The rate of interest on these loans depends on a number of factors such as the tenure of the loan, loan amount, purpose of loan, repayment capacity of borrowers and the cost of the fund of the financier. Both floating and fixed rates are offered to home loan borrowers. The repayment of the loan is generally done through the equated monthly installment method. In the case of borrowers expecting a reasonable growth in their future income, installments may be on a graduated basis.

The Banks and the HFCs also levy a fee for processing the application and it varies from 0.5 per cent to 1 per cent of the loan amount. In addition they also charge an administrative fee of 1 per cent of the loan amount.

Table 3 indicates the amount of housing loans outstanding across all banks as at 31 March 2005 and 2006. There is a significant growth in housing loans in 2006 and housing loans constitute roughly 50 percent of the total retail advances.

Key Issues and Future Outlook

The housing finance market has been consistently exhibiting rapid growth in the past few years. Growth has been largely concentrated on urban areas and in the middle to high income groups, focusing on the salaried class. This growth was partly fuelled by the entry of commercial banks seeking asset growth in a sluggish business environment coupled with the tax incentives on housing loans. The banks, with their lower cost of funds, extensive branch network, capability to provide a range of personal banking services and aided by the average low default rates in housing finance, could expand the market considerably. They however, continued to focus on middle to higher income groups. Lower income groups, self employed and the rural population are by and large excluded. While the middle and higher income groups may continue to access conventional housing finance, increasing attention will need to be paid to the needs of the underserved. Some suggested ways are outlined below:

- Introducing mortgage insurance would definitely help the lending institutions to gain confidence on lending to the lower income groups.
- The high and varying stamp duty across various states on the purchase of property should be reduced and kept uniform across the country or abolished. This would in turn motivate buyers to declare the true buying prices to lending institutions.

- In order to help the lending institutions to raise more long-term funds, securitization of mortgages should be supported more intensively. This is yet to happen for housing finance companies in India.

- Greater transparency in the housing finance transactions would enable borrowers to make a right choice about the product.

Conclusion

Recent experience demonstrates that the formal housing finance sector continues to grow, but still it is elusive for the lower-income groups. This issue needs to be addressed by the State by taking appropriate measures as discussed above.

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Table 3 - Retail Portfolio of Banks (Rs. Millions '00)

Sr. No	Particulars	Outstanding as at end March		
		2005	2006	Percentage Variation
1	Housing Loans	1,34,276	1,79,116	33.4%
2	Consumer Durables	3,810	4,469	17.3%
3	Credit Card Receivables	8,405	12,434	47.9%
4	Auto Loans	35,043	61,369	75.1%
5	Other Personal Loans	85,077	1,18,351	39.1%
TOTAL		2,66,610	3,75,739	

Source: RBI Report, 2006

A Just and Sustainable Shelter - For All?

by M Sc Ann Jennervik,
The Swedish Association of Chartered Surveyors

Introduction

In the March 2007 edition of *Housing Finance International*, N O Jorgensen published a most interesting article on the role of housing finance in alleviating urban poverty ("Housing the No-income Group - The role of Housing Finance in Alleviating Urban Poverty"). It is certainly an issue that needs further attention from housing finance actors and experts, as well as from the financial sector in general. For too long it has been stuck in the "charity corner". The first UN-Habitat global assessment in housing finance conditions and trends of the world shows that quite a limited group of experts is involved today. The scope and actors need broadening from "just" a donor- poor peoples concern. New perspectives and a broader genuine dialogue will add to drivers for further development.

The prevention of slums, which represent an all too big part of housing globally, is an important part of reaching the Millennium Development Goals. Having no security of tenure and no access to functioning financial mechanisms, one billion people are kept from achieving an acceptable housing standard. Surveyors play a key role in establishing rights, and in linking functioning markets for housing and finance. A Chain of Links - a *Shelter Delivery Chain* needs to be developed between the local market needs and the housing finance that is getting global.

During two days of the 2008 FIG¹ Working Week in Stockholm, jointly organised between FIG and UN Habitat, the possibilities of the surveying world and the financial sector in changing this will be the main focus. Providing efficient financing facilities for slum upgrading and basic infrastructure on a massive scale will be required to meet the MDG. Mr Jorgensen highlights useful lessons learned from real life

experience. This article aims to mobilize these much-needed "New actors". Can we carry the baton forward in this relay race, and if so, how?

The Goal is 60 Years Old...

The Universal Declaration of Human Rights 1948 stipulates: "Everyone has the right to a standard of living adequate for the health and well-being of himself and of his family, including food, clothing, housing and medical care and necessary social services." The right to housing should be seen as the right to live somewhere in security, peace and dignity. The right to housing should be ensured to all persons irrespective of income or access to economic resources.

A number of factors must be taken into account in determining whether particular forms of shelter can be considered to constitute "adequate housing" in any particular context. To take these factors into account requires capacity and competence in land policies and legislation, land and geographically related information and spatial information management, construction economics and management, land and property markets, housing finance, valuation and the management of real estate. As already pointed out by Mr Jorgensen in his article, "the implementation of these goals will require the imagination and skills of the best professionals". We will also need to have such professionals available in sufficient numbers in the countries concerned. In short, sustainable capacity building.

The Doubtful Charm of Informality

The housing market of today is not inclusive. It excludes almost half of the world from having access to formal, regulated and reliable financial sources. It is the 'institutional' rather

than 'technical' obstacles that present the biggest barriers. For example, different policies for pricing and licensing make 'easy' access to spatial data a major challenge. Not to mention the small print in the housing loan agreements and the multitude of financial instruments, the lack of impartial advice, and...

Progress creates poverty through constraints on the access to land. Urban poor do not automatically benefit from the social and economic progress to which they provide a crucial contribution. Urban poverty in the midst of social and economic progress is related to the conditions under which land is made accessible for individuals and for the community at large. This connection between poverty and land is established both directly and indirectly. Land prices and rents directly influence the peoples' income at disposal, and land prices indirectly gives an effect on profits, investments and wages.

Informal land markets provide economic opportunities for the wealthier and increases the cost of housing for the poor. Contrary to common sense, informality is not a cheaper or an opportunistic way to "beat the system". The urban poor in informal settlements often pay more than residents in the formal city for services of much lower quality. The reason is simply that the informal market is the only way for many poor and middle-class families to access the city. The predominant form of access to serviced land is through informal market transactions, and no longer through squatting or invading. More than two thirds of new housing in Latin America is built outside the formal market.

Making the Markets Work

To make the markets work, independent information on prices and market value is of

¹ International Federation of Surveyors. Please find more information, invitation and how to register at: www.fig.net/fig2008/

course essential. Access to market is built on information. The financial cost for housing is closely linked to the security in tenure and the transparency of the housing markets. "Personal or household financial costs associated with housing should be at such a level that the attainment and satisfaction of other basic needs are not threatened or compromised. In accordance with the principle of affordability, tenants should be protected by appropriate means against unreasonable rent levels or rent increases."²

Slums represent a market. The "demand" side, of 3 billion people needing new housing in the coming 25 years - a little less than 100 000 housing units per day - corresponds to financial needs. The amount is staggering, but we are also talking about 40% of the world's population. Applying the Human rights-perspective on the fact that each third city inhabitant has inadequate housing, because the adequate is unaffordable: *slums represent a market failure!*

Slum-dwellers in general also pay more for less financial services. *Residents* in informal settlements and slums are already making significant private investments in upgrading their housing and communities, particularly when the tenure is considered secure. They have shown incredible capacity to leverage savings and make gradual improvements to their shelter and basic services according to their own personal or household affordability thresholds.

There is a gap between alternative forms of tenure and the corresponding financial mechanisms, by which the urban poor can access housing finance. While the formal mortgage market caters for individuals with leasehold and freehold title, more effort is required to develop appropriate financial mechanisms for alternative forms of tenure, such as group titles, or intermediate options, such as licences for temporary occupation, progressively increasing land-use rights, etc.

Connecting and Strengthening the Shelter Delivery Chain

Building up *the key institutions* that can manage the public systems providing *key public goods*³ is - at best - "a slow process". Not until the state can set up an enabling regulatory framework for this, the poor will stop paying relatively more for inadequate services. And the poor do pay for their housing.

So, what could be done at the global or international level? We need to start working together! We need to openly start sharing information and experience. We need to look beyond our immediate gain and understand the larger picture. Affordable and adequate housing is a problem for "Us" - not for "Them". It needs to be addressed by developing global partnerships, stretching out to reach each other. A Dialogue based on real-life experience and brought to the table by each participant could pave the road to functioning financial markets for housing finance. Careful thoughts shall be given to what type of result that can be achieved in short term, to whom it should be delivered and in what form.

Answers will be sought through a well-prepared Dialogue during the FIG Working week in June 2008. We will build on strengthening and linking existing initiatives. IUHF members are core actors in this effort to bridge the gap between housing and finance. Therefore you are especially welcome! To take part in the preparations, please visit www.justnsustshelter.org. This website is a tool for bringing the core actors together, sharing the latest and most relevant information, preparing the Dialogues for the Stockholm Seminar, and exchanging views and experiences through the Forum.

This initiative has been taken by the two responsible agencies in Sweden for key public goods in housing markets and housing finance⁴. These institutions have developed from a policy based on the need for integration, justice and equality, to combat overcrowding and poor living conditions, less than a century ago. Today we face a reality where global actors and local needs outpace the institutional development on a national, and even more, municipal level.

Through this start of a Dialogue on *Improving Slum Conditions through Innovative Financing*, we shall build on our collective experience and knowledge, while understanding the roots to the problem. It means:

- *Inviting our Networks.* Locating and highlighting the untapped resources.
- *Submissions to a Homepage with open access.* Making the existing information available and user friendly and at the same time building the capacity to use it.
- *A long-term engagement.* Continuity in implementing and follow-up of effective measures.
- *Open minds and hands on.* Design and implementation of effective land and housing policies and functioning financial mechanisms.
- *Fostering a genuine Dialogue.* Urban planners, experts involved, decision makers, the financial sector and the affected persons and groups.

The work programme is outlined. Please visit www.justnsustshelter.org. Let us meet!

² The right to adequate housing (Art.11 (1)) : 13/12/91. CESCR General comment 4. CESCR General comment 4 UN Office of the High Commissioner for Human Rights.

³ For example, policy coordination with land, infrastructure, legal, and financial systems, appropriate regulations in respect to land-use, zoning, and building, enforceable property rights and a range of tradable property rights, a sustainable finance system for the housing sector including effective assistance to those unable to look after their own shelter needs, and timely provision of infrastructure.

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The Role of Primary Mortgage Institutions in Housing Delivery

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Introduction

The housing market remains one of the most dynamic and sustainable areas of investment in the property world. Demand for housing remains high due to among others, high rates of new household formation especially in a populous country like Nigeria; high rates of urbanization and rural-urban migration; the need to replace dilapidated stock and the popularity of residential real estate as a lucrative area of investment capable of yielding better returns than other classes of investment.

Although these characteristics are well understood and recognized in Nigeria, housing still remains an area where there is acute shortage due to inadequate access to the basic resources needed – especially land and finance. Presently, the housing deficit stands at 14 - 17 million; up from the eight million that was identified in the eighties and 13.64 million estimated by Ajakaiye and Falokun (2000) for the 2000-2005 period. Over 72 million Nigerians are either homeless or live in rented substandard houses in areas best described as slums. This accentuates the need for an evaluation of the structures, agents and processes that have been put in place to alleviate the problem so far.

Housing production regardless of the scale is bedevilled with the problems of inadequate access to funds. Hardly are investors able to mobilize adequate funds from private savings or retained business earnings because, characteristically, house building is a high cost and high-risk venture. Until recently, most developers in the formal sector had recourse only to commercial banks at excessively high interest rates and on stringent conditions, which

did not encourage mass production of lower market types of housing units. Commercial banks by nature require relatively high liquidity levels and as such do not favour long term lending such as is necessary for housing development. Individual homebuilders sought finance either from informal sources such as ajo (traditional thrift societies) or esusu (rotating savings and loan associations), age / trade groups, traditional money-lenders, friends or family. Classified as micro credit organizations (see Osamwanyi and Megbolugbe, 1987, and Nubi, 2006), these sources were convenient and accessible. They operated on the basis of third party guarantees and relied on peer pressure to ensure repayments but they were unsecured and lacked the magnitude of accumulation of funds required for large-scale impact and full coverage of the requirements even of the individual investors. At best, they were used merely as supplements to personal savings or retained earnings.

It can be safely said that serious efforts to reform the housing sector began in the late eighties with the establishment of the National Housing Fund through Decree No 53 of 1989 and the subsequent announcement of a national housing policy in 1991. Since then there have been series of reforms aimed at encouraging private sector driven housing production and home ownership as a preferred tenure type among the teeming urban population.

The aim of this paper is to highlight the role of Primary Mortgage Institutions (PMIs) in housing provision both in terms of expectations and with respect to their achievements so far. Peculiar problems are highlighted and suggestions made for improvements where appropriate.

Emergence and Characteristics of PMIs in Nigeria

Primary mortgage institutions emerged after the Federal government's attempts to deregulate the financial sector in the late eighties and early nineties. Following the establishment of the National Housing Fund by decree (No 53 of 1989) and the announcement of the 1991 National Housing policy, the Primary Mortgage Institutions Decree was passed in 1993 to facilitate speedy implementation of financial reforms envisaged under the national housing policy. The purpose was to encourage the establishment of financial institutions capable of mobilizing savings and facilitating greater access to loans in order to popularise home ownership by individuals wishing to build or buy their own homes and for large-scale private builders producing houses for sale.

PMIs were conceived as retail mortgage institutions operating under regulatory and operational supervision of the Federal Mortgage Bank (FMBN) as the apex institution from which they could also source funds for on-lending.

Out of 256 PMIs that existed in 1996, only 90 have remained on the CBN list of registered PMIs till date and the bulk of these (58 or about 60%) are located in Lagos (Nubi, 2006). The majority of these are limited liability companies - a reason why it has been difficult for many of them to meet up with the N100 million capitalization requirements. In view of recent reforms in the banking sector, it has been suggested that rather than wait for an official directive, PMIs should begin to work towards increasing their capital base to between N500million and N2 billion to enable them

attain higher levels of functional efficiency. To date, most of the PMIs operate as small companies with few employees and only a few have so far accessed funds from the National Housing Fund for housing finance purposes. Also, operations are to a large extent not IT-enabled and the majority do not have enough branches to cater for users of their services. Further, methods adopted for dissemination of information on their services have been severely limited.

Operational Modalities and Performance of PMIs

Ideally, PMIs should encourage prospective owners to open accounts with them and deposit regularly to save towards their home acquisition projects. Upon receipt and approval of applications from qualified customers, they should pay the full value of houses to developers on behalf of their subscribers and retain the title documents as collateral until subscribers fully defray the cost through instalment repayments of loans along with the interest charged. When defaults occur, they should be able to recover the full value of the loans from the foreclosure of the arrangement. Where a thriving secondary market exists, they should be able to package their portfolio of loans for sale to other investors in the capital market through securitization and from the proceeds embark on further lending operations.

However, this has not been so among Nigerian PMIs. In their bid for greater profit, several PMIs engage in direct construction of houses for sale thereby competing with the operators they are expected to be financing. Many also engage in non-housing businesses, which are very risky. Nubi (2006) discovered that no less than 80% of PMIs sampled in his study were engaged in direct construction for sale. 57% were concentrating on LPO financing, 60% were into merchandising while 70% were more accustomed to giving out short-term loans to traders. As a result, the performance of PMIs has been abysmally low in terms of the number of housing units actually produced through their financial assistance. Very few could boast of 100 units produced through their loans.

Some Characteristics of PMIs in Nigeria

1.0 Ownership Profile	
Private Ownership / Limited Liability	62%
Government Owned	24%
Building Societies	14%
Total	100%
2.0 Sources of Fund	
Equity	80%
Access to NHF	10%
Other Sources	10%
Total	100%
3.0 Capital Base as at 2002 (N100m from 2001)	
401 - 500m	3%
301 - 400m	3%
201 - 300m	34.5%
101 - 200m	34.5%
>100m	25%
Total	100%
4.0 Performance (Housing Stock Creation)	
Less than 20 houses	71%
21 - 60 houses	26%
Up to 100 houses	3%
Total	100%
5.0 Time taken for Loan Approval	
Below 3 months	28%
4 - 6 months	25%
7 - 9 months	3%
10 - 12 months	3%
Over 13 months	41%
Total	100%

Source: Adapted from Nubi (2006)

THE ROLE OF PRIMARY MORTGAGE INSTITUTIONS IN HOUSING DELIVERY

However, it is envisaged that with the new modalities put in place during the last stakeholders' workshop, PMIs are now expected to be more proactive in accessing loans on behalf of their customers; the situation is bound to improve. This new procedure is illustrated in the figure below:

Step 1	Savings mobilisation	Opening of Accounts for subscribers
Step 2	Collaboration / Negotiation with developer on behalf of qualified and interested customers / subscribers who have met the down payment criteria	Partnership with developer guaranteeing purchase of units
Step 3	Application to FMBN for loan on behalf of customers listing their names and account details (FMBN to give loan at 6% for on-lending)	Evidence of unit cost of houses and subscribers names must be provided
Step 4	PMI pays full value of the houses to the developer and retains the title documents as collateral while collecting instalment. Repayments from beneficiaries @ 10% interest	Developer has funds to jump start another project units are delivered for occupation. Loan repayments accumulate for lending.

Developers on their part can obtain short-term construction loans from the NHF upon evidence that they have a ready list of subscribers from a PMI as an assurance that the houses to be built will be taken up and paid for. The PMI will then collect proceeds through instalment repayments, which will be remitted to FMBN.

Problems affecting PMI operations

Problems bedevilling the sector can be evaluated from two perspectives - that of small scale individual borrowers (the micro scale) and at the macro level. Both are treated together below.

UNDP as stated in Merrett and Russel (1994) quoted in Nubi (2006: 14 - 15), criticised the wide disparity between what is actually needed to improve the housing situation in developing countries from the perspective of the majority of the citizenry and what actually exists in practice as entrenched by the PMIs in the formalised sector.

While the demand is for flexible terms and repayment schedules, assistance with land acquisition, short term loan maturity,

assistance with self help efforts, detailed information in popular local languages that people can easily understand, accessible locations for deposits and access to funds etc, the formal structure provides what appears to be the exact opposite in each case and hence excludes the vast majority of persons who most need the assistance of the institutions. Apart from these, the situation in Nigeria is made worse by:

- *Low capitalization.* PMIs' capital base of N100m is inadequate to finance housing on the scale the economy requires. In fact, most of them have not been able to grant individual loans exceeding N3m and generally they have also not been able to cope with the volume of demands from their customers. Although access to NHF is available to them through the FMBN, there is no doubt that a stronger capital base would better position them for greater efficiency in their operations.
- *Inadequate mobilization of funds* through savings deposits. Although as Okunmadewa (1998) has noted, low incomes and a poor savings culture are to a large extent to be blamed for this, PMIs too have not explored the full potential of their position in this area.

- *Poor and uncertain state of the economy and socio-political environment* makes it difficult to take advantage of off shore funding opportunities.

- *Distractions and failure to confine activities to savings mobilization and mortgage lending.* Nubi (2006) found that a vast majority of PMIs in his study sample (80%) engage in direct construction of houses for sale instead of giving loans to purchasers or house builders - a dangerous combination of credit risk with construction risk. 60% were engaged in LPO financing and merchandising. 70% operate as commercial banks.

Too many PMIs still engage in import/export business, merchandising, and oil business financing etc, in order to gain short-term profits. This remains possible because of inadequate monitoring and enforcement of the rules by the CBN, NDIC and other monitoring bodies.

- *Inadequate impact* arising from the above and problems of poor positioning and operational lapses e.g.

- Inadequate numbers of branches and inaccessible location of PMI outlets making it difficult for the average Nigerian to access their services
- Poor level of public awareness of services and opportunities due to non use of local languages in information dissemination thus leading to tacit exclusion of the vast majority
- Inadequate use of mass and other media to publicise their products
- Inadequate loan servicing capacity of most Nigerians due to low and irregular income, rising cost of living and poor saving culture
- Tardiness in processing loans for approval. The processing according to the findings of Nubi (2006) takes an average of 13 months and among the sampled PMIs, none gave more than 10 loans per annum before 1998.

- *Loan Defaults* This is one of the risks of the business but many PMIs seem to have a good approach to minimizing this through appropriate credit risk assessment, proactive assistance and counselling. The use of mortgage default insurance will however ensure greater improvement.

Until the latest reforms, most PMIs (62%) charged interest rates of between 10 and 20% while 12% charged up to 40% for commercial mortgages. This could be attributed to the prevailing mode of operation at the time under which PMIs sourced funds at high costs from commercial banks OR a misperception of their role as mortgage financiers.

Recommendations

1. PMIs should be encouraged to improve their capital base in order to empower them for greater effectiveness in financing housing. This will afford them wider coverage and enable them access greater pools of funds.
2. The FMBN, PMIs, NSE and other stakeholders should hasten the operationalization of the Secondary Mortgage Market (SMM) as a means of mobilising more funds for mortgage origination and encouraging greater efficiency in the sector. The potentials are great with the new pension reforms and emergence of Real Estate Investment Trusts (REITS) as a wider market of potential investors in mortgage-backed securities is gradually building up. Full operation of the SMM will boost liquidity and make the market more competitive and eventually reduce cost to mortgagors. Necessary legal and regulatory frameworks should be properly designed and put in place while existing laws that constitute potential obstacles should be reviewed accordingly. Illustrations of the advantages of such moves can be seen in recent developments in the UK and USA markets.

In the UK, saturation of the main market has prompted a relaxation of mortgage lending rules to accommodate people with low credit rating and those that are self employed – categories normally regarded as high risk prospects. In 2004, £41.2bn sterling was lent to persons in this category – an increase of 9% over the previous year (Datamonitor, 2004 as reported in Financial Standard of 15 May, 2006). As a result, house sales have increased by 37% in England over last year's rate. In the USA, a new trend has begun of longer term mortgage lending of up to 50 years as against former average of 25 years. This is because prices of homes have increased and buyers need a longer time horizon in order to keep instalment payments within affordable range. Although such long-term borrowing is risky in a variable rate environment, the fact that such a pattern has emerged can be interpreted as one of the dividends of a competitive mortgage environment responsive to market needs.

3. On the micro scale, there is need to hasten the review of the Land Use Act to provide adequate recognition of the types of interests and transactions that would emerge in the new dispensation. Land titles need to be made clearer and more fungible. The present incorporation of IT-enabled record keeping and land data management is a step in the right direction but State governments need to perceive the broader advantage of relaxed land market controls as against myopic treatment of land matters only in terms of revenue generation. In this regard, consent to transactions should be cheaper and less cumbersome to obtain.
4. PMIs should be encouraged to desist from distracting activities - LPO financing, short term commercial lending etc. Perhaps the Central Bank's monitoring arm can put a framework in place to ensure this.
5. PMIs should also create more public awareness of their products and endeavour to attract patronage across a broader section of society than hitherto. This will require opening branches where prospective customers are and providing publicity/information materials in local languages which people can easily understand.
6. PMIs should also better position themselves to be able to access off shore funds either through partnership arrangements similar to one which was recently initiated between Guardian Express Assurance Limited, Howell Campbell and Associates and First Premier Mortgage Corporation, Maryland, USA to market a mortgage plan to assist home ownership in Nigeria. Subscribers are expected to save up to 25% of the cost of any house they wish to acquire up to N15million over a period of 36 to 60 months. Guardian Express will then finance the 75% balance, which the subscriber will be expected to repay over a period of 10 to 15 years.
7. NIESV and Estate Surveyors in general need to empower themselves to be more proactive as initiators, through consultancy services, of housing investments on larger scales than have been seen so far. There should be more collaboration between NIESV and stakeholders in the industry in the shaping of policies and monitoring of their implementation. Also, greater

involvement in the packaging of housing development schemes, loan sourcing etc. is called for. In fact, there are no better professionals to embark on housing development than estate surveyors who, by training and experience, have better understanding of all the issues involved than others in the building industry.

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