Housing Finance in the Aftermath of the Crisis

Implications for emerging markets, policy and regulatory responses

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Agenda

- Indirect adverse impacts
- Issues to be resolved
- Regulatory response
- Government Interventions
Landscape after crash: indirect adverse impacts (I)

- Different and indirect contamination effects in emerging markets: different outcomes in individual countries
- Portfolio performance and credit contraction concerns

<table>
<thead>
<tr>
<th>Downward trend</th>
<th>Stable development</th>
<th>Upward development</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hungary, Romania, Latvia, Russia, UAE</td>
<td>Most countries in Sub-Saharan Africa</td>
<td>Brazil</td>
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<tr>
<td>Mexico</td>
<td>Korea, Malaysia</td>
<td>Jordan, Egypt</td>
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<tr>
<td>South Africa</td>
<td>Colombia</td>
<td>China (?)</td>
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</tbody>
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Examples: differing developments in individual emerging markets after recent crisis
## Failures in market discipline

CDOs of subprime MBS issued in 2005 – 2007

<table>
<thead>
<tr>
<th>Rating</th>
<th>Estimated 3-year default rate</th>
<th>Actual default rate</th>
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</thead>
<tbody>
<tr>
<td>AAA</td>
<td>0.0001</td>
<td>0.10</td>
</tr>
<tr>
<td>AA-</td>
<td>0.05</td>
<td>12.03</td>
</tr>
<tr>
<td>A+</td>
<td>0.06</td>
<td>20.96</td>
</tr>
<tr>
<td>A-</td>
<td>0.12</td>
<td>36.65</td>
</tr>
<tr>
<td>BBB+</td>
<td>0.34</td>
<td>48.73</td>
</tr>
<tr>
<td>BBB</td>
<td>0.49</td>
<td>56.10</td>
</tr>
<tr>
<td>BBB-</td>
<td>0.88</td>
<td>66.67</td>
</tr>
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Source: Donald Mac Kenzie, University of Edinburgh
Landscape after crash: indirect adverse impacts (II)

- Macro effects: growth, unemployment (Mexico), inflation (Turkey, Ghana)
- Explosive cocktail: risky loans (forex), loose standards, complex structured finance excessive foreign refinancing, undetected real estate bubbles, specialized non depository lenders, unregulated intermediaries, weak financial regulator
- Exposed Eastern and Central European Region
- Closed private RMBS: distrust in mortgage securitization (issuance limited for banks to access CB liquidity)
- Insulated smaller and simpler markets untied to international capital markets (ex: Sub-Saharan African countries, except South Africa)
- Better reaction in countries experienced with crisis (ex: Colombia, Thailand)
Landscape after crash: issues to be resolved (I)

Duration of downturn of real housing prices (from peak to bottoming out)

- On average, house price downturn bottoms out after 6 years
- Decline in real house prices from peak to trough averages 35.5%

Source: Reinhart, Rogoff
* Year of crisis
Issues to be resolved (II)

- Unsatisfied demand in emerging economies (Asia, Africa, LAC)
- Credit contraction: less accessible HF
- Housing not perceived as safe asset class anymore
- Confidence crisis of investors towards private mortgage securities
- More conservative lenders and regulators
- Confusion between lower income and “subprime”
- Unsustainable model of specialized non-depository lenders
- Tensions between tougher regulations and anti-crisis fixes
- Need to better regulate primary and secondary mortgage markets
- Time to promote residential rental markets
Landscape after crash: the reform agenda (I)

- Strengthen the regulatory and supervisory framework
  - Monitoring of systemic and correlation risks
  - Risk-based capital (not just credit risk, but also market and liquidity)
  - Invest more in consumer information and protection
  - Better monitoring of credit risk (LTV, DTI, amortization, etc.)
  - Stress testing
  - Anti-cyclical provisions

- Close market infrastructure gaps
  - Improve property valuation standards
  - Improve credit information systems
  - Modernize titling, land use reforms to facilitate affordable housing
  - Develop house price indices (Thailand, Morocco, Mexico)
The Reform Agenda (II)
Diversify domestic funding sources

- Transform core deposits, develop contractual savings

- Is SBPE the solution buffer or a time bomb to Brazil HF system?

- Revive private mortgage securities
  - Establishment of central liquidity facilities (access to long-term financing): Armenia, Pakistan, Indonesia, Tanzania, Egypt
  - Development or improvement of covered bond legislations (Mexico, Uruguay, Morocco, Poland, Hungary, Turkey)
  - Securitization to be revised: simpler, transparent, incentives by originators/servicers to manage risks, better standards, master servicers, better credit enhancement, revised regulations
  - Critical role of CBs / Governments to support liquidity
Secondary spreads of 5 Year Euro denominated Jumbo covered bonds (mid-swaps)

Source: Bank of America Securities – Merrill Lynch
Regulatory Response in Emerging Markets

- Promote sounder primary mortgage markets
  - Ex: Romania, Latvia – mortgage debt restructuring guidelines
  - Ex: Hungary – proposal aimed at tightening credit standards
  - Ex: Poland – Recommendation S (applied to forex loans: credit information and adjusted credit underwriting)
  - Ex: United Arab Emirates (UAE) – Central Bank is drafting new rules to regulate mortgage loans and protect consumers
  - Ex: Mexico - CNBV to regulate Sofoles issuing debt bonds as banks and to introduce new rules for mortgage lending reserves
State Interventions in Emerging Markets (I)

- Countries active to compensate adverse effects upon housing for moderate/informal income households (or continue pre crisis work):
  - Risk-sharing insurance or guarantee funds,
  - Develop suitable products by more market layers: lease to own, housing microfinance, more affordable mortgage loans, etc
  - Smarter credit related subsidies (ideally promoting savings)
State Interventions in Emerging Economies (II)

- State interventions to support housing market development
  - Brazil – Minha Casa Minha Vida Program
  - India – Affordable Housing Initiative
  - Morocco – Land/tax incentives for developers active in affordable housing + guarantee fund for mortgage lenders
  - Egypt – National Housing Program: credit buydown subsidy program (for lower income households) + free land for developers
  - Mexico – Counter-cyclical funding role of SHF + more subsidized loans by Infonavit
Public Intervention in Mortgage Insurance (I)

- Motivated by market failures (e.g. lenders apprehensive towards higher credit risks related to lower or informal income lending)
  - FOGARIM, Morocco: Guarantee Fund for irregular income
- Coverage of systemic risk + setting of prudential lending standards
  - Ex: Canada: high LTV loans require mortgage insurance
  - Ex: Mexico: higher LTV loans require MI to access RMBS
- Lack of global private MI (re)insurers active in emerging economies
- Lenders to be closely involved to facilitate implementation
Mortgage Default Insurance (II)

Pre-requisites

- Limited coverage (75% in Serbia, 70%-50% in Morocco, 25%-35% in Mexico) to avoid adverse selection and looser credit standards
- Operate according to actuarially sound principles (premiums/reserves)
- Specific regulatory framework (for insurer and insured institutions)
- Independent professional management
- Different possible forms of private public partnerships: (re)insurance
- Increased interest from more countries including Brazil but no panacea (Mali, Algeria, Philippines, Jordan, Lithuania, China, South Africa, etc.)
Strategic Pillars of the World Bank

1. Establish building blocks of sound housing finance markets
   - Improve supply of affordable housing (rental, owner-occupied)
   - Resilient and balanced funding system
   - Prudential regulatory framework that take into account the cyclicality of real estate markets and the vulnerability of some lending institutions
   - Information systems + attention on whole value chain in housing

2. Expanding access to finance of moderate/lower income groups
   - Support implementation of suitable mechanisms
   - Emphasize catalyst role of state to expand accessibility
   - Implementation of targeted and effective subsidy schemes
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