THE REVIEW OF INTERNATIONAL FINANCIAL REGULATION: Implications for Housing Finance in Emerging Market Economies

4th Global Conference on Housing Finance in Emerging Markets

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Whither International Financial Regulation: Implications for Housing Finance

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I. The Decalogue For The Reform Of The International Financial Regulation

1. Strengthening of the global capital framework
2. Introducing a global liquidity standard
3. Anti-cyclical regulation (capital and provisions)
4. Systemic risk (how to deal with the “Too Big To Fail” problem)
5. Strengthening accounting standards
6. Improve incentives
7. Widening of the regulation/supervision perimeter
8. Sounder securitisation
9. Taxes to financial intermediation
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II. Housing Finance and financial inclusion in Emerging Market Economies

Housing Finance:

• At the roots of this crisis. Implies a significant part of reform efforts are focused on HF

• HF: Local and global nature at the same time:
  • Local: policies present wide differences
  • Global: securitisation implies spillover effects and contagion channels (as shown by this crisis)
  • Tension:
    • Trend towards harmonisation and standardisation desirable in some areas
    • … but local regulations often disconnected

• Important role of the government

Financial inclusion policies: especially relevant in Emerging Market Economies (EMEs)

• This crisis was not a result of a financial inclusion process
• Important ensuring that present reforms do not imply a step back in financial inclusion
• Enlargement of FSB, BCBS positive to increase sensitivity of standard setters to EMEs views
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- **Consumer Protection** is key:
  - Avoid predatory lending, teasing rates, unfair resetting
  - Prepayment penalties. Related to the debate on FRM vs. ARM.
  - Regulation of advertisements

- Promote **Consumer counselling** and **Financial education**

- **Disclosure, transparency, simplicity** (both for mortgage products and securitisation).

- Securitisation:
  - Need to promote **transparency** of loan portfolio in securitised assets
  - Properly **align incentives** of all agents (loan officers, mortgage brokers, servicers, investors, rating agencies, debtors…).

- **Government Sponsored Entities** (US, Fannie and Freddie): clear identification of role, objective, status (government guarantee), long-term viability (or sunset clause if purpose clearly temporary…)
The crisis is NOT the end of securitisation
Securitisation’s rationale still applies:
1. Mobilising illiquid assets
2. Transfer credit risk to more diversified holders (willing to buy risk)
3. Efficient use of scarce capital
4. Better asset-liability management. Proactive handling of maturity mismatches
5. Financial deepening
6. Reduced cost of credit (IMF estimates: 10% increase in securitisation implies a decrease of between 4 and 64 bp in yield spreads)
7. In EMEs also:
   • develop capital markets
   • foster investment
   • fund housing development (scarce resource)
8. Some of the emerging lines of consensus:
   • Covered Bonds (CBs) model promising (“double protection”)
   • Re-securitisation: increase in capital requirements (example: from 20% to 40% for AAA CDOs) (see BCBS, July 2009).
   • EMEs: more control of indirect credit risk as a result of unhedged borrowing in foreign currency of debtors with income denominated in domestic currency
EMEs: risks of **mortgages denominated in foreign currency**:
- Foreign exchange risk (currency mismatch between banks’ assets and liabilities): manageable
- Indirect credit risk (foreign currency risk of unhedged borrowers with income denominated in domestic currency): more difficult to cover. Argentina 2001, Estonia 2009…

**Mitigating measures:**
- Monitoring, disclosure, financial education
- Stricter enforcement of prudent risk-management practices
- Higher risk weights for foreign currency loans in CAR
- Limits to affordability ratios
- Increase compulsory downpayments for housing purchase
- Increase provisions and stricter loan classifications
- Increase reserves requirements for forex loans/mortgages
- Introduce liquidity requirements for foreign currency loans
- Introduce ceilings on foreign exchange exposures
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1. Sound underwriting
2. Avoid regulatory arbitrage
3. Originators: skin in the game
4. Treatment of Off Balance Sheet Entities
5. Funding liquidity
6. Credit Rating Agencies
7. Counter-cyclical treatment of housing bubbles
8. Disclosure of market-wide practices to ensure market discipline in international securitised markets
V. Specific Regulatory Proposals in Housing Finance Regulation

1: Sound underwriting standards

- **Verification of Income and Financial Information**
  - Guidelines to verify borrower’s income, employment, debt, and other financial qualifications for repaying a mortgage.
  - Penalties for borrowers and originators who misrepresent such information.

- **Reasonable Debt Service Coverage**
  - Ensure reasonable debt-to-income coverage for mortgages
  - EU Directive:
    - LTI max 33.3% -- 50%
    - LTV max 80%

### Housing Affordability Index, 2004

<table>
<thead>
<tr>
<th>Country</th>
<th>Average house-price [thousand USD]</th>
<th>Household income [USD/year]</th>
<th>Maximum interest rate of a typical loan</th>
<th>HAI [%]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Croatia</td>
<td>81,000</td>
<td>12,900</td>
<td>8.5</td>
<td>63</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>64,000</td>
<td>13,700</td>
<td>7.0</td>
<td>95</td>
</tr>
<tr>
<td>Hungary</td>
<td>51,000</td>
<td>13,200</td>
<td>9.5</td>
<td>95</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>29,000</td>
<td>2,900</td>
<td>13.0</td>
<td>30</td>
</tr>
<tr>
<td>Poland</td>
<td>76,000</td>
<td>7,400</td>
<td>6.5</td>
<td>45</td>
</tr>
<tr>
<td>Romania</td>
<td>46,000</td>
<td>6,000</td>
<td>10.0</td>
<td>46</td>
</tr>
<tr>
<td>Russia</td>
<td>68,000</td>
<td>2,700</td>
<td>15.0</td>
<td>10</td>
</tr>
<tr>
<td>Slovenia</td>
<td>184,000</td>
<td>16,700</td>
<td>6.5</td>
<td>42</td>
</tr>
</tbody>
</table>

*Source: Country reports.*
V. Specific Regulatory Proposals in Housing Finance Regulation

1: Sound underwriting standards (cont.)

Realistic qualifying mortgage payments

• Problem: ARM, teasing rates
• Analysis of borrower's repayment capacity should be based on mortgage payment amount over the whole life of loan
• Ex: Canada – underwriting criteria for ARM equivalent to FRM 5 years

• Effective appraisal management
  • Sound appraisal/valuation management guidelines.
  • Independence.

• No reliance on house appreciation
  • Not consider future house appreciation

• Recourse
  • Mortgage loans should be backed by full recourse to the borrower (Joint Forum recommendation)

• Commercial property:
  • More demanding requirements for preferential treatment
V. Specific Regulatory Proposals in Housing Finance Regulation

1: Sound underwriting standards (cont.)

- **Mortgage insurance:**
  - Supervisors should explore public and private options
  - Supervisors should require adequate mortgage insurance in instances of high LTV (e.g. above 80 percent). Ex: Canadian model:

- Some other countries: **limits on LTV**
  - Romania: maximum loan-to-value ratio of 75% and maximum payment-to-net income ratio of 35% for mortgage credit (affordability ratio)
  - Hong Kong: max LTV 70%
  - Croatia: max LTV 75%
  - Chile:
    - Mortgage bills: max LTV 75%
    - Endorsable mortgage loans: max LTV 80%
    - Non endorsable mortgage loans: no limit

- **Basel II:** higher Capital Adequacy Ratios for higher LTV loans:

<table>
<thead>
<tr>
<th>LTV</th>
<th>Basel I</th>
<th>Basel II</th>
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<tbody>
<tr>
<td>LTV &lt; 80%</td>
<td>50%</td>
<td>35%</td>
</tr>
<tr>
<td>LTV 80%-95%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>LTV &gt; 95%</td>
<td>100%</td>
<td>150%</td>
</tr>
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</table>
V. Specific Regulatory Proposals in HF Regulation

2: Avoiding regulatory arbitrage ⇒ for different types of mortgage providers:

- Coordination among regulators
- Consistent mortgage underwriting standards
- Consistent regulatory oversight and enforcement

• Background:
  • Serious concerns on the lack of harmonization of regulatory treatment of intermediaries, originators, underwriters, among different supervisors and regulators.
  • Patchwork approach. Differences in enforcement regimes.

• Goal:
  • Ensure similar products and activities are subject to consistent regulation, standards and examination. Avoid regulatory arbitrage.
  • All mortgage market participants should be subject to appropriate and consistent levels of regulatory oversight and enforcement.

• Challenge:
  • Effective communication and coordination among supervisors.
  • Requires changes to some countries legal and supervisory regimes
V. Specific Regulatory Proposals in HF Regulation

3. Skin in the game: originators should retain more exposure
   • Need to tailor to types of securities and underlying assets. BCBS proposal: 5% (also in EU)

4. Treatment of Off Balance Sheet Entities (OBSEs):
   • Improve disclosure
   • Avoid regulatory arbitrage incentives: uniform capital requirements, sound consolidation requirements
   • Liquidity facilities (for OBSEs like SIVs, Conduits…): tighter requirements
   • ABCP: avoid liquidity mismatch
   • Acknowledge reputational risk

5. Liquidity:
   • Liquidity Coverage Ratio (LCR): 30 days stress scenario. Issue: inclusion of CBs in highly liquid assets; haircut; 50% limit
   • Net Stable Funding Ratio (NSFR): one year horizon
V. Specific Regulatory Proposals in HF Regulation

6. Credit Rating Agencies (CRAs):

- Banks (and investors) should become less reliant on external ratings.
- Reduce or eliminate regulatory reliance on CRAs (i.e. in Basel II)
- Different scale for rating of structured products
- Incentives: change of issuer-pay model?
- Comply with IOSCO Code of Conduct
- Measures already adopted by some regulators:
  - **EU and Japan**:
    - Registration requirements
    - Endorsement mechanism
    - Supervision
7. Counter-cyclical treatment of housing bubbles (on top of capital and provisioning ongoing reforms):
   • Adjustment factor to correct price increases in LTV valuation
   • More extensive use of “mortgage value”: equilibrium value over the medium to long term, free from “speculative” misalignments
   • Additional measures in Pillar II to ensure that capital adequately reflects the different phases of the cycle
   • Capital surcharge when credit growth exceeds certain threshold
Counter-cyclical treatment of housing bubbles (cont). Some measures adopted in Asia:

- Increase of provisions for property loans (India 2005)
- Increase of provisions for certain geographic areas (Korea)
- Limit of exposure to property market (HK: 40%)
- Minimum downpayment for non-owner occupied houses (China)
- Floor on mortgage rates (China)

<table>
<thead>
<tr>
<th>Asian experience with macroprudential tools</th>
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<tr>
<td><strong>Objective</strong></td>
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<tr>
<td>--------------------------------------------</td>
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<tr>
<td>Manage aggregate risk over time (ie procyclicality)</td>
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<tr>
<td>Manage aggregate risk at every point in time (ie systemic oversight)</td>
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Source: Caruana, J: Macroprudential policy: working towards a new consensus, 2010
V. Specific Regulatory Proposals in HF Regulation

8: Appropriate public disclosure of market-wide mortgage practices

- Longer term challenge: harmonize mortgage lending practices across borders
- Countries need adequate public disclosure concerning the health of their mortgage market (incl. underwriting practices and markets trends)
- The FSB should consider establishing a process to periodically review countries against sound mortgage practices, and results should be made publicly available.
- The FSB should consider monitoring the health of the mortgage market (eg country volumes, funding needs, bond performance) to highlight emerging trends and to consider recommending adjustments or changes.
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- Tightening of international financial regulation: need to **ensure compatibility of all the reforms**. Need for calibration of combined impact of reform package. Transition periods to avoid pro-cyclicality

- EMEs: need to make compatible:
  1. **tightening of financial regulation** in accordance with international standards and
  2. **continuation of financial inclusion** policies.

- This crisis was not a problem of financial inclusion, nor related to the proximity banking model predominant in EMEs. Important that **reforms keep in mind what went wrong**. **Most reforms do not address EMEs problems ⇒ should not apply to them**

- Riskier mortgage loans will be regulated more strictly: teaser ARMs, forex loans, etc

- **Consumer information and protection** key. **Transparency** to ensure market discipline

- **Counter-cyclical capital and provisions**: necessary, but challenging for EMEs: need to calibrate the cycle. **Dynamic provisions should be introduced in the good times.**
V. Some final comments

• Underwriting: **more attention to affordability ratios**

• **LTVs limits** and/or incentives (related to securitization, insurance).

• Identifying bubbles requires reliable **data** on housing markets & prices

• **State support** to Housing Finance necessary in EMEs. Need to target subsidies. Avoid tax distortions between owner occupied housing and rental markets. Support to residential rental markets

• **Securitisation** will come back with a sounder basis. Covered Bonds model?

• **Housing micro-finance** important for low income segments

• **Housing saving schemes** promising. Importance of well designed incentives

• EMEs: Need to improve HF markets **infrastructure**: appraisals, registry, foreclosures, enforcement

• Need for **consistency** of **regulation and enforcement** of different intermediaries to avoid regulatory arbitrage
Thanks!

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