Panayotis Thomopoulos: Recent developments in housing finance

Speech by Mr Panayotis Thomopoulos, Deputy Governor of the Bank of Greece, at the European Finance Convention, Athens, 31 January 2007.

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Ladies and Gentlemen,

It is a great pleasure and an honor to address such a distinguished audience of practitioners in the area of finance on such a topical issue. Before speaking succinctly on the housing market and its interlinkages with the rest of economy, I would like to say a few words about long term issues and challenges. In particular in the field of mortgage lending the effects of today's decisions will be felt during the next 25 or even 35 years, when the last installment of a 25 or 35-year loan is repaid.

Today most analysts and market actors seem optimistic about future developments and this because markets are mainly preoccupied with the short term, and tend to project current trends into the future. And if you want to lengthen the time horizon, many analysts, traders etc. will cite the famous words of J. M. Keynes, "over the long run we are all dead", thus bringing the discussion back to current developments and a focus on the short-term. Indeed reading the figures and short-term forecasts about the world economy presented by the OECD, IMF and others one cannot but be optimistic. The global economy has been growing at an average rate of almost 5% since 2001, and the short-term prospects point to a continuing high rate of growth. The world has not seen such a high long-term rate of growth since the 1950s and 1960s. Moreover, whereas in the past only a small proportion of the world population (1/4) were reaping the dividends of growth, nowadays nations accounting for almost ¾ of the word population are benefiting from rising standards of living, though to varying degrees.

Are these revolutionary developments and do they signal a new area of the world history? I believe the answer is yes and yes. The developed world, that is essentially EU, US & CND, Australia, N. Zealand, Japan & Korea, are no longer the only global actors, and the consequences of the economic upheavals are being felt in the world political arena, cultural attitudes, social behaviour and unfortunately the climate across the globe. Every year more than 50-60 million people from emerging market countries, essentially in China and India, are entering the market economy, both as consumers and as producers of tradeable goods and services. The previous great leaps were the absorption into the market economy of only 70 million people from Korea, Taiwan, H.K. and Singapore in the 1970s and 1980s, that is, over a 20-year period, and the absorption of an additional 30 or a little more million from the European transition economics over the last 10 years. But those leaps implied a very slow rate of absorption, considerably smaller than that of the last few years which has witnessed the absorption into the market economy of large population categories from China and India.

The economic growth of the emerging and transition market economies, though a positive world development as it is associated with diminishing income inequalities among countries leading to more balanced world development, has, nonetheless, produced some major shocks as reflected not only in the rising trend in energy and raw material prices but, more importantly, in the increasing pollution of sea and land, global warming due to carbon dioxide emissions, etc. Indeed, if we want to prevent a major climatic catastrophe on a global scale, the waste of energy, water and other resources, not only by emerging economies but also by developed economies, will have to be reversed at a great cost in the future. Just as under international accounting standards future liabilities, such as companies' pension liabilities, are deducted from company incomes, so the future cost of today's actions should be taken into account. Accordingly today's global and individual countries' GDP growth rates, which supposedly measure the improvement in the standard of living, should be adjusted downwards. Such an adjustment is necessary as there is too much complacency and the hidden economic costs of today's actions are not properly taken into account. Any new era brings along new problems, requires new solutions and increases the range of potential crises and risks, which are not properly gauged, as they are not yet calibrated.

Moreover, by projecting today's favourable trends, financial markets often generate a benign perception of future developments, which do not, however, reflect all the underlying forces at work. Indeed, the significant transformation of the financial environment has led to heightened and new risks associated with the introduction of innovative products (e.g. derivatives), the existence of highly leveraged non-regulated financial institutions and markets, combined with world liquidity increasing considerably faster than the value of the underlying real assets. Regarding world politics most probably China and later India will become great world powers but during the transitional period before a new world order is established the risk of political tensions cannot be ruled out, and their impact on the world economy and markets cannot be fully understood today.

Another area of concern is that the benign inflation trends of the last few years, which are almost exclusively due to moderate wage claims in the developed countries and which have more than offset the impact of the rise in energy and raw material prices, may not continue for ever. Indeed, over the last 5 years average real wages have been stagnant, and probably more than one-half of wage earners have experienced real income losses, while profit margins have been rising strongly. Lately we have been seeing the first signs of a change in labour behaviour and, although, over the next couple of years wage growth will probably continue to be about 2% in most developed economies, this cannot be taken for granted over the medium to longer run.

To sum up there are risks in the horizon: a) steep rising costs from global warming, pollution and the quick rate of depletion of non-renewable resources; b) apart from the proximate concerns regarding the Middle East imbroglio there are political risks further down the road, which are associated with the emergence of new global powers during the transition to a multi-polar world; c) crisis in segments of the financial markets which may necessitate drastic measures at a high cost to prevent a spill over; and d) increasing income inequality in the developed world may trigger, especially in Europe, a backlash with sudden wage increases putting pressure on inflation. Seeing today's 10, 20 and 30-year interest rates on mortgage loans, and low bond rates in general, I have the feeling that these risks are not fully reflected in interest rate spreads.

Focusing more on the specific subject of interest today, I am afraid that, in addition to financial assets, some countries' real assets, including housing are overvalued today, and a disorderly adjustment of asset values could have important effects. This is what has been called the $400 trillion question.

Financing of the housing sector is an area of economic analysis that has come to prominence only in the last couple of decades. Two, perhaps inter-related, developments have contributed to this new prominence, financial innovation and the wide gyrations in housing prices that have been observed in the last two decades, starting with the real estate collapses in Japan and other Asian countries. No one can claim that house prices never fall or that real estate is an area of boring stability. In recent years, the housing sector has thus emerged as a major channel for the transmission of monetary policy but also as a reason for concern regarding financial stability.

Financial innovation has allowed financial intermediaries to structure their products more in line with consumers' demands and to take on more risky products as the possibilities of securitizing their exposure has increased. Since housing finance is normally very long-term – typically mortgages are for twenty to thirty years – the mismatch of maturities is correspondingly more acute. Securitization allows financial intermediaries to overcome this problem to some extent and thus facilitate the extension of more credit in this market. However, transferring risks does not mean that nobody will pay the bill if conditions deteriorate and those who will pay the bill are usually also bank clients (or the banks may pay compensation to holders of securitized bonds in order to minimize reputational risks); thus "securitization does not completely insulate banks" and this simple maxim tends to be ignored today.

Consumers for their part have a wider array of options to choose from and this has led to an increase demand for mortgages. At the same time, the removal of many regulatory restrictions and the increased integration of markets, especially in Europe, have led to increased competition and an overall reduction in interest rate spreads to the benefit of consumers. Many borrowers who were previously excluded from the market now have access to affordable credit and can enter the housing market. A particular phenomenon that is widespread across the Atlantic but is starting to spread over here is equity withdrawals, whereby homeowners use the accumulated equity in their houses to finance current expenditures. Whilst this may depress savings in an economy, it may also improve its resilience to shocks, as the interest rate on mortgage-backed loans is normally lower than for other forms of consumer credit.

Another issue that may be acting toward increasing the risks in the economy is the propensity of market participants to take on risks which they do not fully understand. A specific example is the proliferation of mortgages in foreign currencies, which make borrowers vulnerable to little understood exchange rate risk and lenders to credit risk, which may remain hidden for a long period as long as everything goes well. Of course, extension of credit to new borrowers at a time of diminishing spreads coupled with little understanding of risks may be a source of concern regarding financial stability, especially if house prices become stretched.

This brings me to a second issue, of housing finance as a channel of monetary transmission. Obviously, as households take on more housing debt, they react faster and more strongly to interest rate movements, thus allowing the Central Bank through their interest rate policy to have a greater influence on macroeconomic activity. A faster and fuller pass-through of interest rates facilitates the conduct of monetary policy and enhances its effectiveness. In this context much depends on whether mortgages are with fixed or floating interest rates. Countries, of course, differ widely on this, for historical, legal or other reasons.

Whether the expansion of the mortgage market is responsible for the often-observed significant increases in housing prices is a moot point. There are many good reasons that support higher prices, such as demographic changes, as smaller families require more overall living space, expectations that real and nominal interest rates will remain low, and regulatory restrictions that curtail land supply. Surely, the ample liquidity that has been pumped into the markets in recent years has created conditions conducive to speculative excesses. Most countries in the euro area have not yet had any experience of significant correction in nominal housing prices. It is possible that both borrowers and creditors have underestimated this possibility and in some cases both credit expansion and housing prices increases look questionable.

Developments in Greece are a good illustration of the forces that operate throughout Europe. After the full liberalization of the financial sector we have seen a real revolution of housing finance. Since 1996, mortgages have more than doubled as a share of banks' portfolios, while there was a fivefold increase of mortgage debt as a proportion of GDP. The first trend was the result of falling interest rates and increased competition that led banks to search for new areas of profitable expansion. Households, on the other hand, facing improved conditions, as exemplified by that fast growth of GDP and lower costs of borrowing, reacted quite rationally by increasing their indebtedness. The ratio of homeownership in Greece has been among the highest in Europe, fluctuating around 80 percent in recent years. Mortgage demand has probably been used to improve housing conditions rather than enter the market for the first time. Demand from economic immigrants has supported this trend by allowing existing homeowners to sell their entry-level properties in order to move to more expensive ones. As I see it, we are still in the process of stock level adjustment, as the level of mortgage indebtedness at 27% of GDP is still below the European average (of about 38%), though the gap is narrowing rapidly.

House prices increased fast at the start of this period relative to disposable income, although we are seeing some leveling-off lately. Research conducted at the Bank of Greece by Sophocles Brissimis and Thomas Vlassopoulos shows a two-way causal relationship. Increasing house prices have allowed or forced households to borrow more, while at the same time the availability of housing credit has fuelled house prices.

The steep increase in mortgage lending, starting from a very low level, did initially create problems for the quality of Greek banks' portfolios. Initially, the ratio of non-performing mortgage loans appeared quite high, but over the last six years it has almost halved. With pressure from the Bank of Greece and following the development of more comprehensive credit control systems, the ratio of non-performing mortgage loans now stands at about 3½ percent down by 1 percentage point in two years, indicating a much better ability of Greek banks to manage their risks. This is reinforced by the fact that mortgages in Greece are normally lower as a percentage of market values than elsewhere. Moreover, Greeks are more sentimentally attached to their homes than are Americans and other Europeans, and therefore perceive house-eviction as a terrible social blow. It was useful that the rapid expansion of mortgage credit took place at a time of high growth and macroeconomic stability since this allowed banks to absorb the "growing pains" emanating from their entry in this market without impairing their stability.

Developments in South-Eastern Europe in many ways resemble Greece's experience in the preceding decade. One significant difference is the relatively low stock of existing housing units, which are often of a rather low quality for today's needs. There is thus a much more urgent need to upgrade and expand the housing stock. Given the relatively benign climate in those countries recently, households may be inclined to overextend themselves. These emerging market economies are starting from a very low level of financial development, which translates also into a very low level of housing credit. This low level of housing credit is more a result of financial under-development rather than of skewed credit policies on the part of financial institutions. It is to be expected therefore that housing credit will expand quite fast for the foreseeable future as the financial sector expands toward advanced economies' levels. This is quite a rational reaction of creditors and borrowers to the economic situation and may accelerate for those countries that join or are expected to join ERM II and later EMU. In those countries, the reduction of the risk premium and perceived policy stability will also encourage credit expansion. While from a macroeconomic point of view all these developments may seem quite predictable, there is a fear that both borrowers and lenders in these countries may not have an adequate understanding of the risk they are taking. Financial institutions may lack the necessary expertise to manage a fast expansion of their housing loans portfolio, and in the rush to gain market share they may extend credit to ever-riskier borrowers. While the ratio of non-performing loans in South Eastern European countries does not look threatening now compared with other emerging markets, one should note that overall household credit in these countries is much lower and thus more manageable than elsewhere and the macroeconomic situation has been quite propitious.

Two further differences are worth noting: a strong penetration of foreign-owned banks and a large percentage of loans are in foreign currency. The first special characteristic is the significant penetration of foreign banks in these countries, which typically control more than half of the local market. I should add here that Greek banks are quite active in this area and are expanding fast. Foreign banks may be a source of stability. They bring with them a much longer experience, direct access to the capital markets of mature economies and, last but not least, they are supervised by their home country's supervisors who also have a longer experience. In the particular circumstances of these countries, it is also worth noting that foreign banks and their supervisors are less prone to succumb to pressure from local politicians. The challenge for them is to adapt their experience to the realities in their host countries.

The second interesting characteristic is that the highest rate of growth of loans in foreign currency is not in countries with a fixed exchange rate regime, like Bulgaria, but in countries that have a policy of inflation targeting coupled with a benign neglect of the exchange rate. It is true that in recent years the ample supply of liquidity internationally has combined with increased risk tolerance on the part of investors to support a rather stable external environment for emerging and transition economies and in particular predictable exchange rates. While we all hope it is going to continue, we should be well aware that recent years have been a departure from longer-term trends. In addition, in some countries in the region one suspects that a process of real appreciation is taking place, a process that will have to be corrected sooner or later. The current account deficits observed in many countries in the region raise concerns regarding their sustainability. Any loss of confidence on the external side may easily cause some upheaval in the domestic financial market.

Countries in South-Eastern Europe have the advantage of being able to learn from best practices developed in more advanced countries and avoid the mistakes of others. They should take the opportunity offered now by a relatively stable international environment and their domestic fast growth to put mortgage lending on a stable footing. The credit information infrastructure should be strengthened, the legal procedures for dealing with defaults should be simple, clear and transparent, and both banks and borrowers should realize the risks they take, especially as they move to more sophisticated instruments.