Housing Finance: Macroeconomic and Regulatory Implications of the Current Situation

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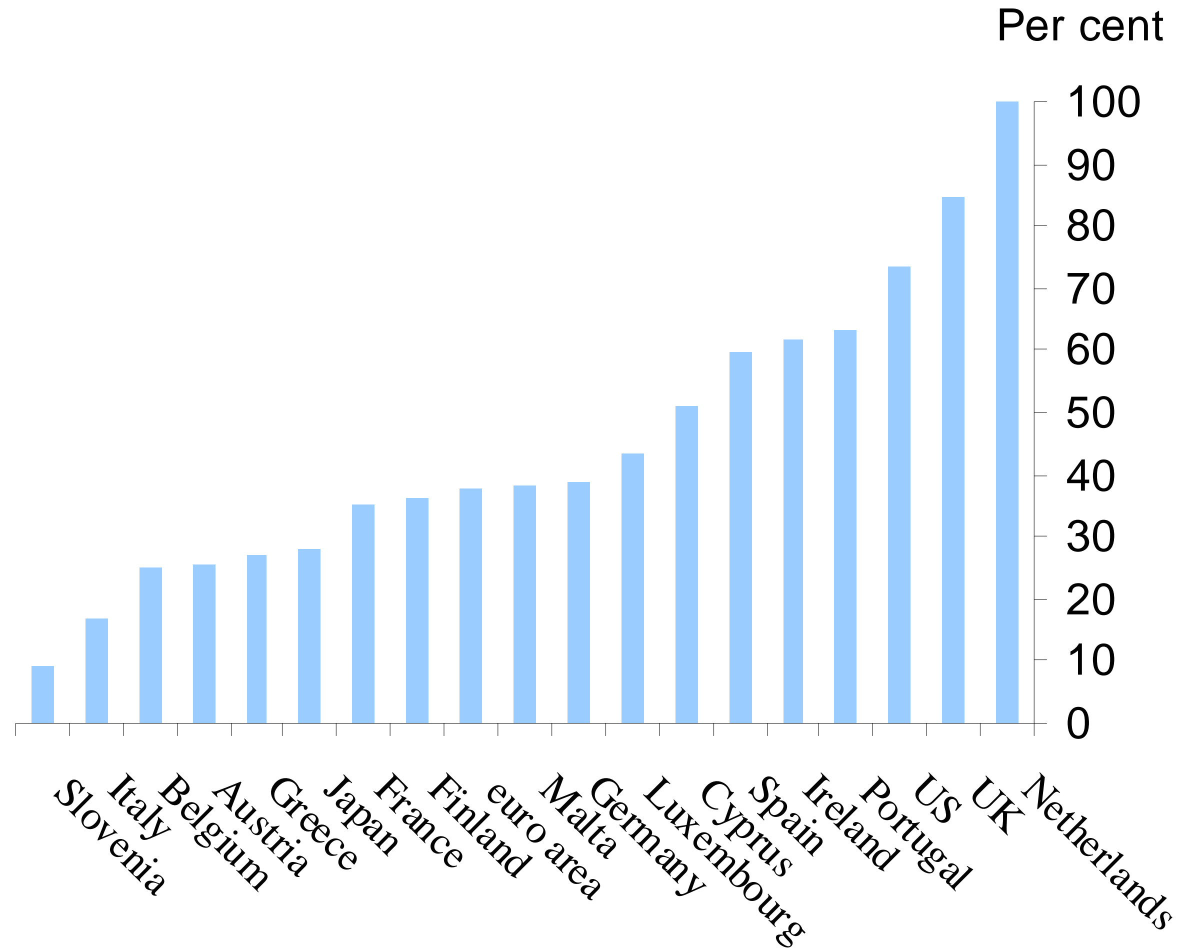
Macroeconomic and regulatory implications of the current situation: where we are now

- Self evidently there have been very great differences between mortgage markets in different countries
- In some countries high levels of mortgage debt – relative to people's realistic income prospects and the values of property – have been available.
- Often these have been at rates that are variable, or on short fixes, generating re-set risks.
- If the reset rate depends on house values that risk is great.
- In some countries this re-set risk is low – eg France and Germany. In others it is substantial: UK, Ireland, Spain and (to some extent) the US.

Mortgage Markets

Country	**Description**
Germany	Almost all mortgages are fixed at rates (~90%).
France	Rates are mainly fixed (70-80%). Variable rates are typically indexed to 3-month or 1-year Euribor, caps on rates are also common.
Ireland	Almost all mortgages are variable.
Italy	Most interest rates are variable (~80%). Rates are indexed to Euribor (normally 3-mth), but the government has introduced a law by which households are now charged over the base rate and the state makes up any loss to banks.
Spain	Almost all mortgages are variable (~95%). The rates are normally reset once a year to Euribor 12 mth plus a fixed spread.
UK	~40% of mortgages are at fixed rates, variable rates are typically charges at a spread over the base rate.
US	Over the last thirty years fixed rate mortgages with options to pre-pay have been the dominant mortgage product. But in recent years adjustable rate mortgages (ARM's) with re-set rates after a few years have become popular.

Mortgage Debt as a % of Nominal GDP



Note: Data are for 2008

Macroeconomic and regulatory implications of the current situation: where we are now

- In some countries loans are often provided via intermediaries – brokers and advisors – who did not face the subsequent risks of people defaulting.
- A substantial part of the lending in some countries was used to create mortgage backed securities, so loans did not sit on the balance sheets of the originating institution.
- This set of factors was relevant in the US and in the UK. It is not at all relevant in others – eg Germany.
- Those countries where many of these factors were present have seen big falls in house prices – the US, Ireland and UK are prime examples.

What then happened

- Lower availability of higher LTV mortgages.
- Lower availability of loans to what you might call sub-prime borrowers.
- Much reduced appetite for RMBS.
- Capital position of lenders weakened.
- Expectations of house price changes dramatically reduced.
- In many cases expectations of substantial and prolonged further falls in prices have become widespread.
- As a result there is a lower supply of, and demand for, mortgages.

What then happened

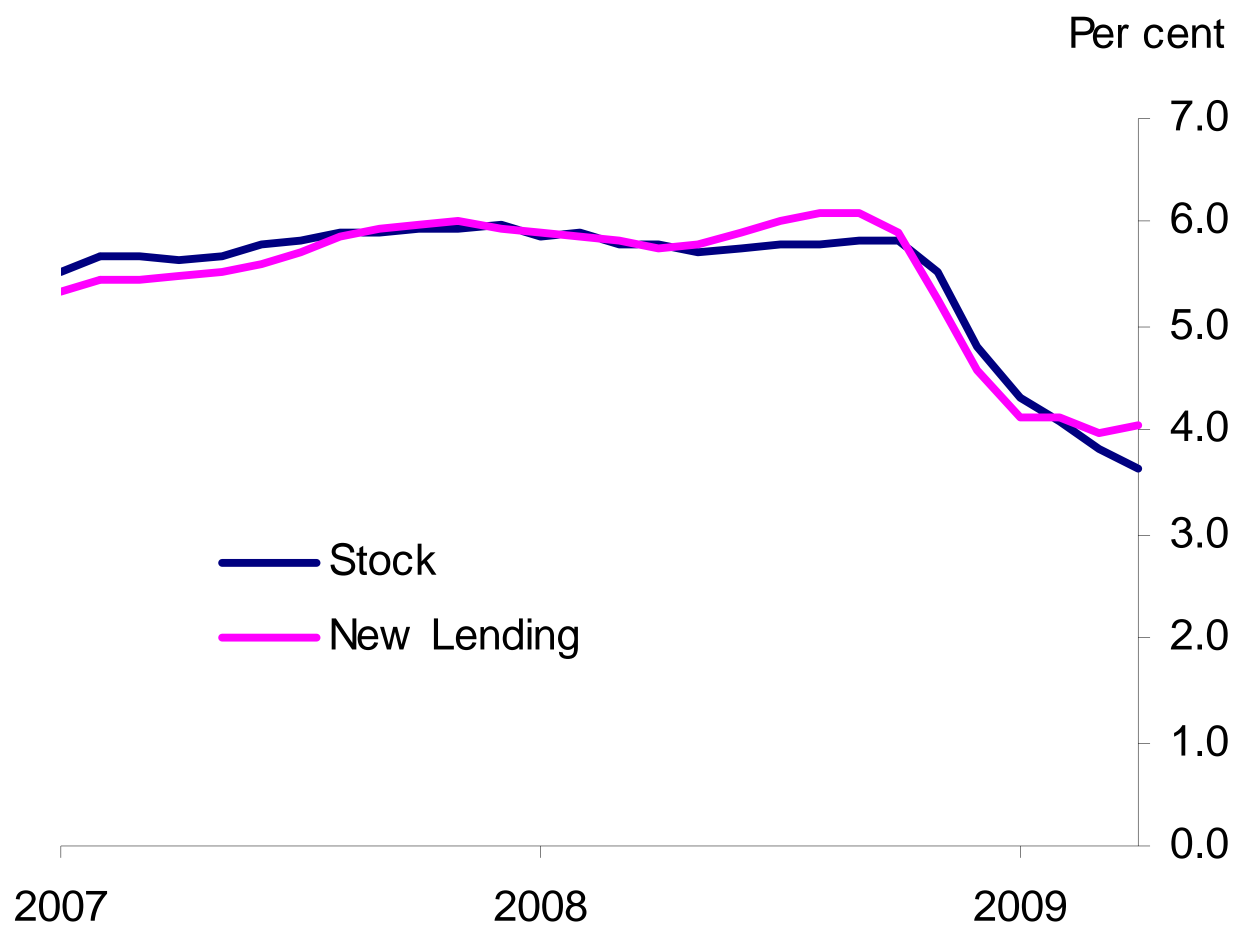
Hardly surprising given all this that in several countries:

- House price falls have been large and sustained
- Lending has fallen very sharply
- Transactions have fallen very sharply.

The wider economic impact

- Knock on impact of all this on the wider economy is not easy to judge and very likely differs across countries.
- Construction has been hit hard – but the scale of construction differed a lot across countries : Spain versus UK.
- Impact on consumer spending is very hard to gauge. In UK most people with mortgages have NOT seen the burden of repayment rise; average rates have fallen. Defaults are up.
- Wealth effect of house prices is not at all clear – either in theory (Ricardo) or in the data.
- In UK not clear that behaviour of renters and owner occupiers to price changes has been very different.

Effective Interest Rate on the Stock and Flow of Mortgage Lending in the UK



The longer run implications

- Welfare impact of lower house prices is NOT all negative – gainers and losers come from intergenerational transfers.
- If LTV ratios and maybe LTI ratios are lower, people will typically buy later.
- This will mean the owner occupation rate will be lower, and the rental sector will be bigger.
- None of these things are bad.

The volatility issues – preventing booms and busts

- If housing costs affect measured inflation – as they should - inflation targeting central banks will respond to house price movements.
- But given the weight of housing costs in a plausible measure of the cost of living this will not mean that monetary policy will respond powerfully to asset prices.
- Short term interest rates are not the ideal policy lever to reduce asset and financial market instability.
- The real issues are regulatory…..and they are both micro and macro. There are no easy answers , but at least the key questions are now clear.

Regulatory questions – micro

- Incentives of intermediaries: Do commission payments – but then no ongoing risk from defaults - generate the right signals?
- In the UK the FSA is now undertaking a broad review of mortgage regulation and this is an issue.
- The information/incentive issues were a main theme of a Review I did for the UK government 5 years ago.
- LTV and LTI limits? Ban self-cert? Are some products so likely to be inappropriate to most people that banning them is a better route to go down than trying to improve information/incentives?
- This is a question of trading off Type 1 and Type 2 errors.

Regulatory questions - macro

- A “macro-prudential” policy lever (or levers) is needed. It could come in the form of Counter Cyclical capital requirements weights.

- There are attractions in this – but we need to know much more about how they affect behaviour. Is Modigliani Miller relevant?

- Limits on aggregate gearing of institutions – a cruder measure.

Final point in answering the regulatory questions:

- Given what we have just been through, it makes sense to take more type1 risk (be too tough when in fact we need not have been) …….because……. we now see cost of type 2 error (don’t get tough when you should have).