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Housing Finance in the Global Financial Market

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*The views expressed here are not to be attributed to the Bank of Canada nor the BIS.

- Presentation today based on the CGFS Report on Housing Finance in the Global Financial Market (Report No.26)

- Current U.S. subprime mortgage market debacle: what is happening vs. CGFS Report?

Background

- Committee on the Global Financial System (CGFS) = standing committee at the BIS.
- End of 2004: formed a Working Group (chaired by Lars Nyberg from the Sveriges Riksbank) to analyze developments in housing finance.
- 17 central banks participated - OECD countries mainly.
- January 2006. Publication of the CGFS Report

Objective of the CGFS Report

- Analyze factors/developments that affect the supply of, and the demand for, housing finance.

- Question: are new developments in housing finance likely to result in risks or vulnerabilities to the global financial system?

Outline

- What do we know?
- What happened? Why did these developments occur?
- What are the implications and the risks?
- Policy issues identified in the CGFS Report.
- Situation today versus risks/concerns in the CGFS Report

What do we know?

What do we know? – Recent developments in housing finance

- A significant number of common developments.
- However, important differences remain.
- Focus here on the common developments/trends.

What do we know? – Supply side

1. Lender structure relatively unchanged.
2. But:

   - changes in mortgage products, with much wider spectrum of options/features

   - reduction in credit restrictions, higher LTV ratios

   - subprime lending in a number of countries.

What do we know? – Supply side

3. Funding of mortgages: increased use of securitization.

U.S. - about 55% of mortgages are securitized

EU countries – about 15% (end of 2004)

Global investors willing to invest in assets backed by mortgages.

Increasingly complex assets backed by mortgages.

What do we know? – Demand side

- Increasing house prices => rising demand for mortgage credit and for more flexible mortgage products (e.g. floating rate mortgages)

- Rising household indebtedness

Why?

Why? – Several factors

- Macroeconomic developments:
  - lower and less volatile inflation => lower nominal interest rates
  - solid economic growth, lower output volatility

Why? – Several factors

- Technology and financial innovations, e.g., quantitative pricing tools, credit scoring, risk management systems.

- Result: mortgage intermediation process made simpler and cheaper => impact on housing supply.

Why? – Several factors

- Financial liberalization and regulation

- Changes in government policies, e.g. creation of mortgage bond markets.

Implications?

What are the implications?

- Positive implications (efficiency) but also some risks
- Efficiency:
  - Better functioning and efficiency in housing finance markets (credit better priced and allocated)
  - Move toward more complete financial markets because of mortgage securitization

Implications and risks for households

- Efficiency: enlarged choice of mortgage products and improved access to credit
- Risks (stability)
  - Households more sensitive to interest rate risk and housing price risk
  - Increased indebtedness => households potentially more sensitive to negative economic shocks

Implications and risks for financial institutions

1- Increased sensitivity to house price developments – but varies across countries

2- In some countries, increased risk-taking because of competition for subprime lending [and originate-to-distribute model]

3- Model risk – underestimation of probability and severity of household default

4- Increased funding risk

Implications and risks for financial markets

- Positive: new assets backed by mortgages => market completeness
- But…
  - Assessment of risks associated with these new assets
  - Ultimate risk bearer? Risk concentration?

Policy Issues

Policy issues

1. Impact on the real economy
   - Housing finance => impact on households and house prices.
   - History => recession exacerbated by adverse developments in housing markets.
   - Concern: ultimate impact on economic activity?

Policy issues

2- Important to ensure that households have appropriate access to information: disclosure and financial education.

3- Important to have appropriate datasets.

4- Increasing importance of financial markets:

- International coordination and information sharing among authorities?
- Financial market weaknesses/disruptions => impact on housing finance providers => impact on the financial system

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Current situation

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Current subprime crisis vs. CGFS Report

A number of risks identified in the CGFS Report have materialized recently:

- rising defaults on subprime mortgages as interest rates reset at higher levels.
- underestimation of losses associated with mortgage defaults
- funding problems
- impact on real economy

Current subprime crisis vs. CGFS Report

- Other factors have likely contributed to the recent events:
  - Global imbalances, low interest rates, search for yield, risk appetite
  - Role of rating agencies
  - Excessive loosening of lending standards in the U.S.
  - Fraud in US subprime mortgage
  - Downturn in U.S. house prices

Conclusion

- Access to housing finance is important because housing plays an important role in economic well-being.
- Well functioning and efficient housing finance markets are important.
- Lessons from the current crisis to improve housing finance systems in the future to promote efficiency without endangering financial stability.

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Thank you