09.30 – 10.45 Session 1B.1 Regulating housing markets

A low-regulation, market-centered approach dominated housing and housing finance policy from the early 1990s, until the Global Financial Crisis exposed its limitations. Now, a decade later, rising housing prices and rents are creating pressure for looser lending terms combined with stricter rental market regulations. The detailed program depends on the interest of the potential participants. The session will focus on two areas: mortgage market regulation and its effects, and rent regulation of dynamic urban rental markets.2

KIRÁLY, Júlia: Asset price and credit bubbles. Regulation of the mortgage markets.

Some preliminary remarks

When real estate prices are increasing, households can afford to buy new houses with high leverage. Banks are offering loans at low interest rates and household can easily refinance themselves. While prices are increasing net worth of households is increasing, as well. However, when asset prices begin to fall then net wealth of households gradually evaporates. Borrowers are unable to refinance their loans and many of them default. Nonperforming loans are accumulating in banks, and banks curb lending. Both real estate price bubble and credit bubble explodes. That is the „Minsky-moment", when deep recession starts.

There are credit cycles in history, which did not generate deep crises. But in the 2000s they did. Under the surface of the great moderation, there were huge imbalances accumulating: overspending households and governments, accumulated debts, overleveraged people and institutions. Endlessly flowing cheap credit. Several countries experienced rocketing real estate prices, extremely low interest rates, escalating mortgage loans and increasing household leverage, which sometimes reached an unprecedented 150 to 200 percent. When the fall of asset prices accelerated, then the Minsky-moment arrived, the credit bubble burst and a deep recession started. The mortgage bubble story varied from country to country, but the essence was everywhere the same.

The US credit bubble was identified by the notion "subprime". "Subprime" literally means that borrowers' rating is below a predetermined level. The notion "subprime" can also be used in a more general way to cover all kinds of loans where the borrower's creditworthiness is low, credit standards are loose, and the risk of loans is high. This general term can be applied to describe the experience of those countries where behavioral credit scoring – and thus subprime in its strict sense - did not exist at all. Some typical examples of "subprime" were the following:

- loans with loan to value (LTV) close or above 100 percent;
- loans with debt service ratios (monthly installment compared to income) close to or above 50 percent;
- so-called "NINJA loans" (No Income No Job No Asset) lent to customers without reliable and sustainable incomes, without proved employment and without sufficient collateral;
- long-term loans provided to elderly couples (both over 50);
- teaser rate loans, where the initial interest rate was zero or very low, but then after the grace period, it increased exponentially;
- unit-linked mortgage loans;

– so-called “jumbo loans”, where the total amount of the loan significantly exceeded the average loan, and the monthly installment exceeded the average income;
– home equity loans, because the borrowers consumed their net wealth and as such were not sustainable.

In the 2000s the share of these types of “subprime” loans increased not only in the US, but also in the UK, Spain, Portugal, Ireland, Iceland, Norway, the Netherlands, Denmark, and in several countries of emerging Europe (Hungary, Poland, Baltic countries, Serbia, Croatia, Romania) as well. Subprime loans in a broad sense were at the heart of all mortgage bubbles. Banks, building societies, cajas, and mortgage banks provided credit to less and less creditworthy customers through less and less risk sensitive agents (credit brokers). The most over-indebted households were largely among the poorest decile of society. When the asset bubble burst, their net wealth went underwater.

In the emerging EU countries all capital controls had to be lifted in the 2000s, therefore in these countries the pre-crisis credit booms started with the spread of foreign currency loans (FX loans, in short). Local regulation could not forbid SMEs and households to borrow in foreign currency. And – with some exceptions - they did. In emerging Europe, high and volatile inflation rates, seemingly stable exchange rates, much higher local than foreign interest rates, lack of long-term capital markets and the expected close accession to the Eurozone (a kind of euphoria) contributed to the attractiveness of foreign currency loans. Intensive capital flow into emerging Europe made the foreign exchange credit boom possible. In these years, capital flow into these countries was historically outstanding and exceeded inflows to other parts of the world. In the booming countries, foreign currency loans amounted to up to 50 to 80 per cent of total household loans. One of the most toxic features of FX lending was the dominance of Swiss franc (CHF) loans in some countries. The Czech Republic and Slovakia avoided the foreign exchange lending boom and avoided credit bubbles. They could avoid this trap, because inflation was lower, less volatile, and so, local interest rates were low, as well. In Czech Republic as opposed to other emerging member states, private ownership of houses was lower, there evolved a more balanced tenure structure, with a large rental market.

Accumulating debt in foreign currency without a natural hedge is usually considered the “original sin”. In currency board countries – the Baltic States and Bulgaria – the risk (and the sin) was lesser, since exchange rates were (almost) fixed. In these countries the currency board could mitigate the risk of FX depreciation, however, could not curb credit boom. In other countries, households indebted in foreign currency had no natural hedge, and were prone to abrupt devaluation. To cover this risk they should have had sufficient reserves, however, they had not. The lack of sufficient reserves was due not only to the borrowers’ carelessness but also to the banks’ irresponsible behavior. As Alexander Lamfalussy kept saying: “*There is no irresponsible borrower without an irresponsible lender*.” Many of the borrowers were not at all, and would never be served in the local currency. However, the low foreign currency installments in emerging Europe made them look creditworthy, they had access to loans and could buy homes they had never dreamed of. Another large group of borrowers focused on the maximum bearable amount of monthly installments and accepted the banks’ generous offer, thus the same installment let them borrow more in foreign currency and enabled them to purchase a more expensive home than originally planned. The borrowers’ irresponsible behavior was supported by irresponsible lenders.

By the 2000s as a result of massive bank privatization, the lion’s share of the banking system in emerging Europe had been acquired by foreign strategic owners. Austrian, Italian, Belgian and French banks dominated the Central European banking market, Swedish banks were active in the Baltic countries, and Greek banks in the Balkans. Through their parent banks, subsidiaries had easy access to international wholesale markets, still most foreign exchange funds were provided by their parents. Thanks to the liquidity awash of the 2000s not only foreign subsidiaries, but local banks as well could make use of interest rate differentials and achieve 4 to 6 percent lower funding costs in foreign than in local currency. At the beginning, banks had access to the un-collaterized international interbank market, later they could finance themselves in the form of foreign exchange swaps. The business was beneficial for both parties: local banks had access to cheap foreign funds and could offer cheap foreign exchange loans, while foreign liquidity providers had access to the high-yield government market. It seemed inconceivable that any of the liquid money markets, and in particular the super-liquid foreign exchange swap market , could ever dry up.

Exploding foreign exchange lending had all the characteristics of subprime lending: loan to value ratios and debt service ratios significantly increased, home equity loans had an ever larger market share, and teaser rate loans and NINJA loans were the rule rather than the exception. However, before the crisis nobody expected a sudden collapse. Though some threats were mentioned, the overall atmosphere was optimistic. The credit boom was not necessarily seen as a bubble, and the Eurozone accession was expected to solve all the difficulties. And then the crisis hit and hope evaporated. Credit bubbles busted.

Several questions immediately emerge: "*Why was the overrun of sub-prime lending not prevented? Why was the FX lending not regulated? Why was the flow of credit allowed to be accumulated into an unmanageable stock, hovering like a permanent sword of Damocles? Why was the regulation so loose? Why didn't public authorities act in time*?" All over the world parliamentary inquiry commissions have been set up to answer these questions. However, after rereading thousands pages of protocol, I still cannot formulate a clear, one-sentence answer.

Authorities were reluctant to regulate and curb the boom. Monetary policy makers were elegantly sitting in their ivory towers and referring to the Greenspan-doctrine. The macroprudential role of central banks and prudential monetary policy were addressed in some academic papers but not in everyday monetary policy council meetings. One of my first initiatives as deputy governor was to investigate the possibilities of restrictive regulation. My staff soon produced a short paper which pointed out that we had no instrument to curb the bubble. Regulation was in the hands of the Ministry of Finance, and our monetary policy tools (as for example, a modified reserve requirement) could be easily bypassed by the banks. The Monetary Policy Department however reacted by saying that they would disagree with any restriction on FX lending, since mass conversion of foreign funds to forint supported the Hungarian currency and, through the exchange rate channel, contributed to our monetary policy target. Actually, we were riding the tiger, hoping that successful monetary policy would bring down inflation, consequently the interest rate disparity might disappear, and foreign exchange lending would be stopped.

But why did the governments promote looser and looser regulation? Were they unaware of the accumulating risks and imbalances? I have found an interesting story I usually tell my students when we are faced with this questions. In 2004 Fed Governor Edward W. Gramlich addressed a warning to President Bush: in this, three years before the onset of the financial crisis, he dissected the motivations behind the surging sub-prime lending, its characteristics and its predatory nature endangering the entire money market. However, he closed his famous warning by saying: "*Despite the caveats, the net social evaluation of these trends is probably a strong positive. The 9 million new homeowners, more than half of whom are minorities and many of whom have lower incomes, suggest that credit and ownership markets are democratizing. Millions of lower-income and minority households now have a chance to own homes and to build wealth*" (Gramlich, 2004). Government were reluctant to intervene, because of the American (Hungarian, Estonian, Romanian…) Dream: let's people purchase their own home! Instead of developing the rental market they passively supported credit bubbles.

Let's summarize the lessons we learned (from the point of view regulations):

1) Rental markets should be developed, where rental market is strong, credit bubble is weaker.
2) Financial stability should be among the primary targets of central banks, and the necessary macroprudential regulatory tools should be allocated to them.
3) Local capital markets should be developed.
4) Creditworthiness of borrowers should be investigated, and subprime borrowers mustn't be served. Regulation should prescribe strict rules on loan to value and debt service ratios, age of borrowers etc.
5) Dangerous products (unit linked mortgages, teasing rates etc.) should be banned.
6) Banks interest rate policy should be regulated. Discretionary rate modification should be banned.
7) Mortgage brokers should be strictly regulated.
8) FX lending to unhedged borrowers should be regulated: either with compulsory insurance or with even more strict regulation of credit parameters.
9) Banks capital regulation should be tightened with special regard to credit bubbles.
10) Banks liquidity should be regulated both in home currency and in FX.

After the crisis the emerging regulatory tsunami aimed at immediately solving all these deficiencies, in some cases with less than more success. Nevertheless, in crisis hit countries (as for example US, Ireland, Hungary, Spain) the new strict rules and the macroprudential policy may help to avoid the next bubble and the next crisis.