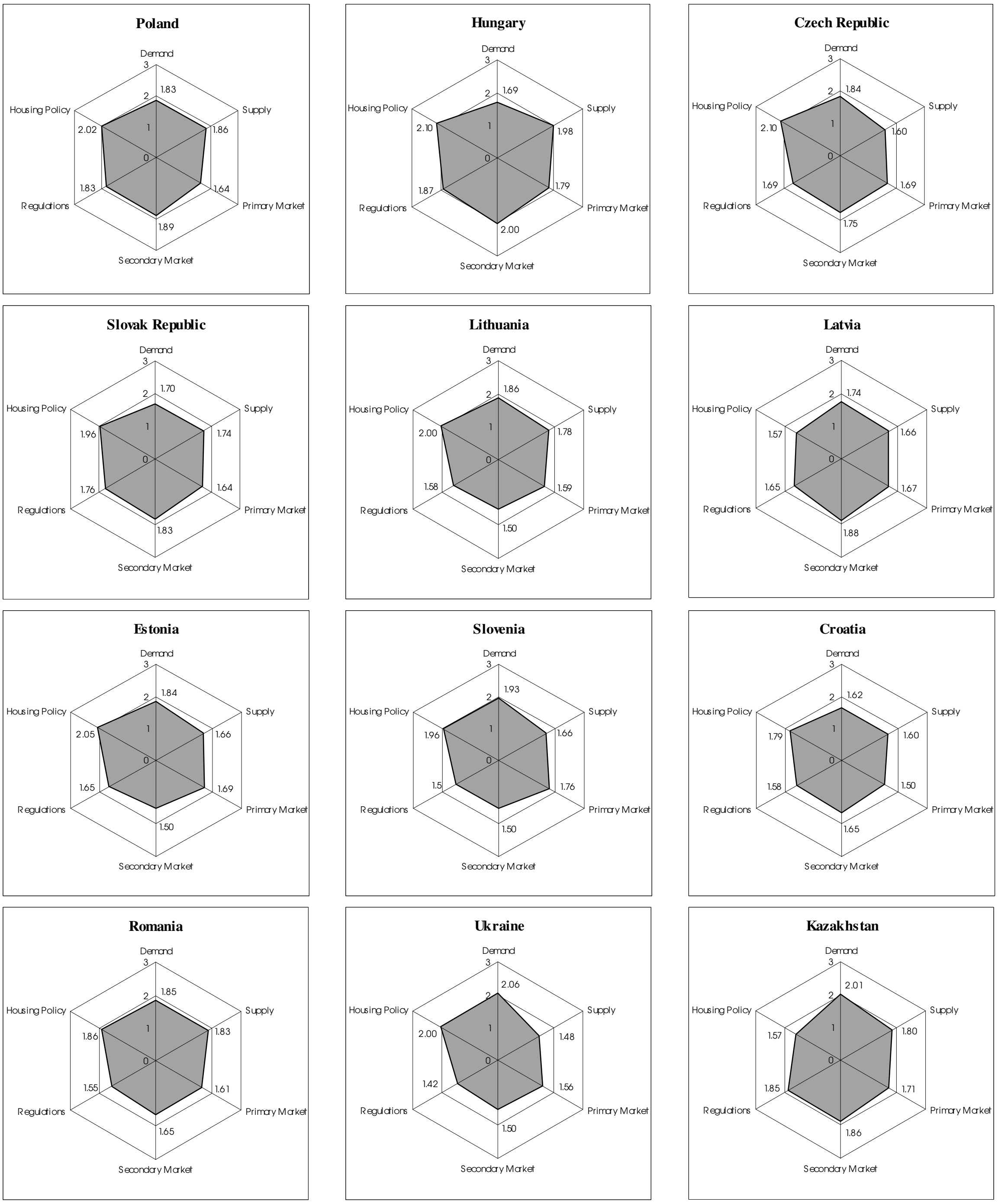
4. Aggregate Results and Lessons

4-1. Dynamics on Housing Finance Markets

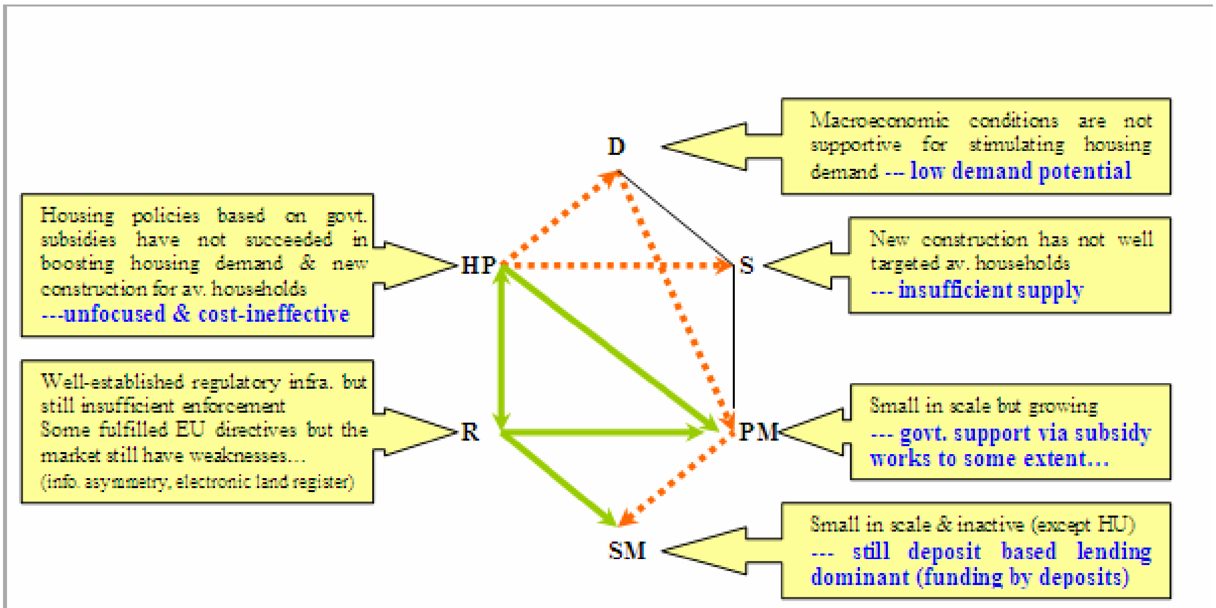
To sum up, foregoing analyses are translated into the following spider charts of housing and housing finance markets in study countries, where the score "2" in each category refers to the EU level as a benchmark.

Figure 19: Total Performance of Housing and Housing Finance Markets in Transition Economies



As indicated in Figure 19, except for housing policy, items on housing demand, housing supply, primary mortgage market, secondary mortgage market and regulations are roughly situated within the EU level in most of study countries. In those spider charts, some dynamics can be seen as follows:

Figure 20: Dynamics on Housing Finance Market in Transition Economies



(Note) D: demand, S: supply, PM: primary (lending) market, SM: secondary (funding) market, R: regulation, HP: housing policy

- Housing policies mostly backed by government subsidies have not succeeded in boosting housing demand and new construction for average households. Most government support measures for housing are not cost efficient (e.g. unfocused subsidies such as savings bonus in some case) and are volatile in unstable macroeconomic conditions (e.g. subsidies costly in inflationary economies such as interest payment subsidies).

- Relatively low demand and insufficient supply of housing exist in study countries. Macroeconomic conditions are not supportive for the creation of housing demand while private developers have not targeted average households.

- This condition of housing market directly links to the housing finance market, which results in a small-scale lending market. However, the mortgage lending market has been rapidly growing particularly in Hungary, which is backed by the active secondary market funding (mortgage covered bonds) and government support via subsidy to some extent.

- Secondary market funding is also inactive in most study countries, where deposit based lending remains dominant, though their mortgage markets are growing. It seems that some types of government subsidies impede the development of primary and secondary mortgage markets in these countries (the obstacle of competition).

- The regulatory framework is relatively well established but not fully covering the weaknesses in housing finance markets; i.e. enforcement of market regulations is still insufficient as compared to the progress of overall financial sector reform. Although some of study countries have fulfilled the minimum standard of the EU (EU directives), their markets still have weaknesses (e.g. time-consuming land register system; i.e. insufficient electronic land register system). Also, some countries lack the core principle of mortgage lending and mortgage bonds regulations.

In this case, it may be difficult to expect the sustainable development of housing finance markets, though this cannot be applied to all study countries.

4-2. SWOT Analysis

To find out the problems to be solved, results of chapters 1 to 3 can be classified into the following strength, weakness, opportunity and threat (SWOT) matrix:

Table 12: Strengths, Weaknesses, Opportunities and Threats surrounding Housing Finance Markets in Transition Economies

Strengths	Weaknesses
- Mortgage products favourable for households (EU level) - Several government support measures for housing (interest payment subsidy/ savings bonus/ preferential tax treatment) - Moderate regulatory and supervisory structure	- Insufficient housing supply for average households - Deep-rooted deposit based lending (especially PL) - Predominant subsidy-based mortgage lending - Not yet popular mortgage securitisation - Insufficient risk management - Untransparency (little available market information)
Opportunities	**Threats**
- Relatively large-scale working age population - Positive GDP growth - Growing mortgage lending - Mortgage securitisation scheme (mortgage covered bonds) - Foreign investors & institutional investors (secondary mortgage market)	- Low housing demand potential (decreasing population/ low-income/ high price & low quality of housing) - Oligopolistic housing finance market (inactive competition) - Still insufficient enforcement of market regulations - Unfocused and cost-ineffective government subsidy schemes (low-income households untargeted) - Lack of financial education

Relatively well organised market infrastructure with proactive regulations will be a strength in the housing finance market in the region. However, inactive residential construction, deep-rooted deposit based lending backed by government subsidy, little used securitisation schemes for funding and a lack of transparency are all crucial obstacles for the sustainable development of housing finance markets.

Against this backdrop, a relatively sizable working age population, positive GDP growth, growing mortgage lending, already existing mortgage covered bond schemes and the interest of foreign investors and institutional investors in the secondary market will provide opportunities to vitalise housing finance markets in the region. Having said that, low housing demand potential, oligopolistic markets by commercial banks, insufficient enforcement of market regulations, unfocused and cost ineffective subsidy schemes, and lack of financial education for market participants will make the market development dull.

So what should be done for the sustainable development of housing finance markets? To develop the market by making the best use of opportunities and strengths, low-and middle-income households should be targeted in the lending market and by housing policy. To avoid threats to fiscal sustainability, government subsidy programs should be reviewed in terms of cost-effectiveness. To protect opportunities from weaknesses, securitisation schemes should be used more. To avoid making the market worse by threats and weaknesses, techniques of controlling risks (credit risk, market risk, prepayment risk, exchange rate risk, etc.) should be established as soon as possible.

From Table 12, eleven general problems that may impede the development of housing finance market in the region can be raised as follows:

1) Low housing demand potential

2) Insufficient housing supply for average households

3) Deep-rooted deposit based lending

4) Predominant subsidy-based mortgage lending

5) Limited mortgage securitisation

6) Oligopolistic housing finance market (inactive competition)

7) Insufficient risk management

8) Insufficient enforcement of market regulations

9) Lack of transparency (little available market information)

10) Unfocused and costly government subsidy schemes

11) Lack of financial education

1) Low housing demand potential

Housing market growth directly links to housing finance market growth. Current macroeconomic conditions in some study countries are not supportive to create housing demand and to vitalise housing finance market (i.e. low-income, high house prices and high interest rate naturally limit households' market access). A stagnant population will directly influence demand for both housing and housing finance markets negatively. Therefore, new demand of housing finance needs to be cultivated from the current working age population.

2) Insufficient housing supply for average households

New construction launched by private developers tends to target higher income people by means of providing luxury (spacious) flats or houses, because housing construction targeting low-and middle income households is riskier taking account of their higher probability of default. Such a small market segment (wealthier households) rarely contributes to vitalising the housing market.

3) Deep-rooted deposit based lending

Traditional deposit-based lending is still dominant in most of study countries, which was popularised by the German building societies. This lending method relies heavily on short- and middle-term deposits (inc. contract savings schemes) for funding. In this scheme, the credit risk is covered only by the accumulated deposits, not flexibly controlled. Furthermore, it takes a long time for borrowers to take loans. Also, this scheme mostly enjoys government subsidies (savings bonuses), which is often used not for housing purposes. Thus, deposit based lending is ineffective in terms of both the asset risk management and the cost performance, and is less customer-friendly.

4) Predominant subsidy-based mortgage lending

The mortgage market in the region is a relatively subsidised market. Most of the study countries have interest payment subsidy schemes for long-term mortgage loans, where the gap between the contractual fixed rate and the market rate is covered by subsidies until the close of the contract. In inflationary economies, this scheme is costly and will impede active competition in the market.

5) Limited mortgage securitisation

Currently, roughly half of the study countries have their own covered bond markets but, with the exception of some countries, do not make the best of a mortgage securitisation scheme. In this context, there is the fact that the mortgage loan volume itself is quite small in scale in the region. Besides, it seems that lenders (issuers) tend to hesitate to use this relatively new instrument because of the complicated process of pooling loans as cover assets. Although there is another securitisation scheme such as MBS, it is not popular in Europe. At present, there is no MBS market in study countries. Important factors include 1) the application of a new system is always costly; 2) there is little experience for market participants as well as policy makers (little accumulated data); and 3) pricing techniques as well as the common valuation rule have yet to be established. Thus, only one securitisation scheme, mortgage covered bonds, is available in study countries.

6) Oligopolistic housing finance market (inactive competition)

The mortgage market in the region is an oligopolistic market dominated by a few large-scale lenders that successfully obtained the right to receive government subsidies. In practice, their privileges to enjoy subsidies have made a barrier to new entrants. (Latvia and Kazakhstan have no government subsidy schemes identified).

7) Insufficient risk management

In most of the study countries, there are low market risks due to government subsidy programs (interest payment subsidy). However, this is not a sound lending structure as mentioned above. Market risks are obviously involved in mortgage lending. Besides, there are several types of specific risks; e.g. credit risks, liquidity risks, prepayment risks, foreign exchange rate risks, etc. The subsidy based lending will hinder the development of risk management techniques in the region, as well does the deposit based lending.

8) Insufficient enforcement of market regulations

Some of study countries have regulations on mortgage lending and mortgage bonds consistent with EU directives (i.e. basic legal infrastructure has been established in the region). However, the enforcement of laws and regulations still seems to be insufficient. Also, compliance with international financial standards has yet to be sufficient.

9) Lack of transparency (little available market information)

Mortgage markets in the region are still not so transparent. There is little mortgage lending information available publicly. There is no information sharing system of mortgage lending including price information and debtors' list. Also in the covered bond market, it is very difficult to get just-in-time accurate market information because issued bonds are little listed in the stock exchange. Most of the transactions are conducted by private placements.

10) Unfocused and costly government subsidy schemes

As mentioned, wide-ranging government support programs are not well targeted. Stiff subsidy programs are often cost-inefficient and ineffective.

11) Lack of financial education

The securitisation scheme such as covered bonds is a relatively new concept in study countries. Due to the complicated instrument, lenders (issuers) tend to hesitate to use this scheme as mentioned above. Also, specific training will be necessary to understand sophisticated mortgage products such as the dual-indexed mortgage (DIM) in Poland and the differed payment mortgage (DPM) in Hungary.

Possible Solutions

For the above mentioned problems, possible solutions might be as shown in Table 13:

Table 13: Possible Solutions

Problems	Possible Solutions
1) Low housing demand potential	1) Cultivate new market segments: little targeted low- and middle-income households
2) Insufficient housing supply for average households	2) Encourage residential construction for low- and middle-income households
3) Deep-rooted deposit based lending	3) Shift to mortgage-based lending with the securitisation scheme
4) Predominant subsidy-based mortgage lending	4) Shift to market-based mortgage lending through reforming subsidy programs
5) Limited mortgage securitisation	5) Effectively use the mortgage as collateral / Consider another securitisation scheme (MBS)
6) Oligopolistic housing finance market (inactive competition)	6) Create an equal footing competitive environment in the market through reforming the subsidy privileges for specific lenders
7) Insufficient risk management	7) Create and use the standard of risk-based asset valuation (common valuation rule in transition economies) / Make the best of securitisation schemes and mortgage insurance schemes as risk control methods
8) Insufficient enforcement of market regulations	8) Fully implement laws and regulations consistent with EU directives and international standards
9) Lack of transparency (little available market information)	9) Establish the information sharing system of mortgage for market participants / encourage public issuance of mortgage covered bonds
10) Unfocused and costly government subsidy schemes	10) Do major reforms of government subsidy programs
11) Lack of financial education	11) Provide training programs and seminars for market participants to activate the housing finance market in transition economies

1) Cultivate new market segments: little targeted low- and middle-income households

In housing and housing finance markets in the region, low- and middle-income households have been little targeted. Although the government has provided support measures for low-income segments by means of the construction of rental housing, this is not a market-based scheme (subsidy programs). If their risks are properly controlled, low- and middle-income households will have a good potential to provide new demand for housing.

2) Encourage residential construction for low- and middle-income households

Promoting new residential construction for low- and middle-income households is indispensable to attract this new demand group to the housing finance market. Also in this case, the risk control to avoid their defaults is a critical issue to be managed.

3) Shift to mortgage-based lending with the securitisation scheme

Taking account of the asset risk management, the mortgage lending system in some countries should shift to mortgage-based lending accompanied by a securitisation scheme. In this regard, Hungary has been successfully moving to a mortgage lending system with mortgage covered bonds, where mortgages are used as cover assets of mortgage bonds (lien) and the risks are transferred to bond investors.

4) Shift to market-based mortgage lending through reforming subsidy programs

The subsidy-based lending scheme is not market-based, which impedes the sound market; i.e. creates a barrier to new entrants by providing a few large-scale lenders with privileges (subsidies). This is also fragile and costly system in inflationary economies (cost inefficient). It is crucially important to shift from "protected" subsidy-based lending to "open" market-based mortgage lending in order to make the market more active and global. Government subsidies should play a supplementary role to vitalise the market.

5) Effectively use the mortgage as collateral / consider another securitisation scheme (MBS)

Because of little experience regarding secondary market instruments, market participants tend to hesitate to use securitisation schemes in most of the countries. Mortgage lenders (mortgage bond issuers) should positively adopt this new scheme, in addition to or in place of the traditional deposit-based lending. In this context, financial education for market participants will be important. To diversify the way to control risks, they should consider the possibility of MBS, learning from UK and French MBS schemes. Poland is one step ahead in this regard (MBS legal framework). However, it should be avoided just to imitate securitisation schemes of other countries. Country specific issues should be scrutinised before developing own securitisation scheme.

6) Create an equal footing competitive environment in the market through reforming the subsidy privileges for specific lenders

To create a sound competitive environment, the subsidy privilege that a few lenders hold should be appropriately reformed in order to facilitate new lenders to enter into the market in the region. The government should take a substantial step to open up to the global lending infrastructure, taking account of the Euro zone market. They have yet to introduced the Euro but are aiming at being a member of EMU (this is not the case for Group 3 (CIS)).

7) Create and use the standard of risk-based asset valuation (common valuation rule in transition economies) / Make the best of securitisation schemes and mortgage insurance schemes as risk control methods

In market-based lending, it is indispensable to create the standard of risk-based asset valuation. Although study countries, with some exceptions, have their own lending valuation rules, there is currently no common valuation rule in the region. Taking account of the trend towards a single mortgage market in the EU, a single valuation rule is indispensable particularly in Group 1(new EU members) and 2 (EU candidates). Also, off-balance securitisation (MBS) might be considered as one of the risk management techniques, where the credit risk and the market risk are transferred to investors. In addition, mortgage default insurance schemes provided by the government and/or private insurance companies will be a promising way to control credit risks (explained in the following chapter).

8) Fully implement laws and regulations consistent with EU directives and international standards

In particular, Group 1 and 2 do their best to fully implement their laws and regulations consistent with EU directives as soon as possible, considering the single mortgage market in the EU (harmonisation).

In parallel, all study countries should do their best to enhance the compliance level with international financial standards, considering cross-border activities.

9) Establish the information sharing system of mortgage for market participants / Encourage public issuance of mortgage covered bonds

For the primary mortgage market, the establishment of information sharing systems (e.g. price sharing, disclosed debtors' list, etc.) will be important to activate the mortgage lending market in the region. Also, for the secondary mortgage market, public issuance should be encouraged to enhance liquidity.

10) Do major reforms of government subsidy programs

In the process of the transition to market-based lending, unfocused and cost-ineffective government subsidy programs are obstacles for the sound development of housing finance markets in the region. To vitalise the market, the reform of subsidy programs should be conducted, taking account of the country specific environment.

11) Provide training programs and seminars for market participants to activate the housing finance market in transition economies

To activate the mortgage markets in the region, financial education for market participants (lenders, borrowers and investors) will be a critical issue. The government and international organisations can contribute through providing training programs and seminars in this regard.

4-3. Lessons

Taking account of the foregoing results, a key for the sustainable development of housing finance market in transition economies is, firstly, to establish a sophisticated risk management system in the market; i.e. a market-based mortgage lending system with secondary market funding (covered bonds/ MBS), targeting low- and middle-income households who have been little targeted so far. Low-and middle-income households involve much higher credit risks than wealthier people. As a sophisticated risk control instrument, securitisation schemes should be more actively used in the market, which will attract institutional investors to the secondary mortgage market. Also, mortgage products for low-and middle-income households such as DIM should be developed but must be plain instruments for borrowers; note the situation in Poland where the demand for DIM has been decreasing because of its complicated nature. Secondly, a housing policy efficient and effective to support low-and middle-income households is indispensable for the sustainable development of the market. To this end, already old-fashioned deposit based lending should be removed step by step from the housing finance system in the region, with the reform of government subsidy programs. Core issues for the development of a well-functioning housing finance system in transition economies are summarised as follows:

For a well-functioning market-based (customer-based) mortgage lending system

- Establish sophisticated risk management techniques of mortgage lending for low- and middle-income households.

- Develop mortgage products to stimulate mortgage issuance. Consider critical requirements of mortgage design for low- and middle-income households (e.g. plain and cost-efficient instruments for borrowers, low-risk instruments for lenders, and effective mortgage insurance scheme).

- Make the best of secondary market funding arrangements (mortgage covered bonds/ MBS) as effective risk controllers.

- Attract institutional investors such as pension funds and insurance companies to the secondary mortgage market, which will particularly contribute to growing mortgage markets, improving liquidity and developing the mortgage market infrastructure.

For a well-organised regulatory structure and well-focused government support measures (housing policy)

- Establish regulatory and supervisory structures fully consistent with EU rules and/or international standards in order to establish the safety and soundness of mortgage lending and funding markets in the region. Basic rules have been already introduced in study countries but more must be done to keep up with the EU legal conditions for a single European mortgage market and/or the international rules on financial markets.

- Establish effective regulations regarding non-depository specialised mortgage-lending institutions. The creation of the legal framework for specialised mortgage banks might be an effective means of vitalising the mortgage market in some countries where the mortgage market is just one part of the total banking sector.

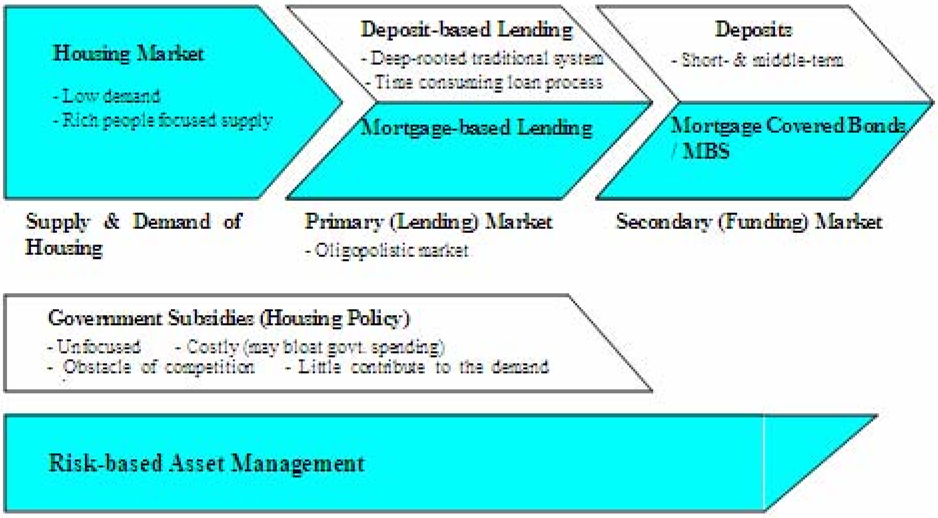
- Establish regulatory and supervisory frameworks suitable to the development of both primary and secondary mortgage markets (e.g. legal framework of alternative funding instruments such as MBS).

- Secure the enforcement of regulations in respective primary and secondary mortgage markets in accordance with EU rules and/or international standards.

In addition, it will be expected that a single mortgage market will bring several synergy effects to most of the study countries (e.g. encouragement of economic growth/ improvement of housing condition). Although some of the countries have achieved EU membership, they have yet to obtain membership in the European Economic and Monetary Union (EMU). It will take a bit of time for those countries to introduce the Euro. In this context, governments in the region might establish short- and long-term action plans taking account of active Euro-based mortgage transactions in the future.

In parallel with that, there is a clear business chance in mortgage markets in transition economies; i.e. the mortgage default insurance business (explained in the following chapter). The mortgage default insurance scheme can be a promising risk management technique in the region, which would enable low- and middle-income households to take high LTV loans and enhance the liquidity of the secondary mortgage market (i.e. as insured mortgages are higher ranking mortgages, cover assets based on insured mortgages enhance investors' confidence in covered bonds). Also, mortgage information collected in the process of the loan assessment can be provided to market participants (information sharing system). For the successful introduction of the mortgage insurance scheme, firstly a government mortgage insurance system and then a private mortgage insurance system will be desirable. In addition to that, the reform of government subsidy programs and the establishment of appropriate legal infrastructure of the secondary mortgage market are prerequisite.

To sum up, as shown in Figure 21, it will be critical to well manage the painted market process for the development of market-based housing finance systems in transition economies.



5. Mortgage Insurance

This final chapter touches upon mortgage default insurance. Mortgage insurance will be a key product as an innovative instrument to reallocate risks, which would be expected to expand the mortgage finance market and further the development of securitisation. The purpose of this chapter is to discuss the benefits of a mortgage insurance system for borrowers, lenders, investors and government, to review the recent progress of mortgage insurance markets in study countries, and to discuss the potential for private mortgage insurance business in the region.

5-1. System and Benefits

The mortgage insurance system is a critical risk control scheme particularly for high LTV lending, which protects lenders and investors from borrowers' default on residential mortgages. The basic mortgage insurance scheme is indicated in Figure 23. Basically, borrowers pay insurance premiums to lenders, besides loan repayments, in order to enjoy the benefits of mortgage default insurance. Then, the premiums are transferred to mortgage insurers via lenders. Mortgage insurance is either obligatory or voluntary for borrowers to take loans, which depends on each country's condition (e.g. Estonia: voluntary scheme). Although mortgage insurance fully protects lenders, the actual amount that mortgage insurers would pay in response to the lender's payment claim will depend on the mortgage (property) value in the general scheme. A typical mortgage insurance product is as shown in Figure 22, where the maximum amount of the mortgage insurer's cover is limited to USD 10,000, for example. According to this scheme, the bank may lose or gain depending on the (sold) mortgage value.

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