CGAP Housing Finance for the Poor
Spring 2008 Newsletter
Big Questions Series

DO THE US HOUSING MARKET TROUBLES AFFECT US?

YES, NO OR MAYBE – Five subject matter experts address whether the financial market turbulence caused by the meltdown in the US Housing Market *__has or will__* affect housing finance and microfinance in developing markets.

YES: Frank Brown, Senior Investment Officer, Gray Ghost Microfinance Fund

We have seen two or three Microfinance CDO funds delay closing because of low investor demand. Our intuition tells us that, since CDOs were a major source of debt capital for MFIs over the past 18 months, the disruption in CDO formations should cause the cost of debt available to MFIs to rise -- via both lesser supply and wider spreads. Thus far, however, it appears MFIs have successfully resisted an up-tick in debt costs. In summary, we regard this as evidence that the disruption will eventually affect MFI debt financing.

MAYBE: James Hokans and David Porteous, Founders, Bankable Frontiers Associates

The sub-prime mortgage market crisis, plus other structural problems, may end up having a severe effect on the US economy as a whole. Countries with dollarized currencies or with close trade ties to the US may suffer, thereby casting a pall over equity markets, economic growth and possible household demand for microfinance. However, the US crisis is not likely to cause to dry up the overall demand for or supply of funds for housing microfinance, which carries very different risks to sub-prime or so called Alt A mortgages. On the contrary, the US crisis may have salutary effects for HMF, reminding lenders that it is always risky to rely on agents with no skin in the game, investors to be more diligent, and regulators that they need to pay early attention to possible credit bubbles. This kind of 'anti-body' effect may reduce the likelihood of credit crises elsewhere.

MAYBE: Helen Ng, Housing Portfolio Manager, Acumen Fund

My answer is really yes and no…so maybe was the result of averaging. If we are talking about housing for the global middle and upper class , then yes, there generally will be a drying up of credit and affordable debt from traditional Western sources as a result of the US meltdown, with the caveat that money will probably more fluidly come from the Middle East and Asia. For the very poor with housing and microfinance, the sector (housing in particular) is in its infancy and there is a growing pool of capital looking to invest in this direction. As the formal housing sector for the poor hardly exists -- conversely, the poor hardly exist in the eyes of the formal sector -- those of us engaged in this arena have been creating our own rules and products in the process. As a result, the opportunities we see are partly shielded or excluded from the turbulence of the US housing market.

YES: Lauren Moser, Vice President, Shorebank International

A large percentage of $11 trillion of U.S. mortgage debt was securitized into various marketable instruments over the years and sold to investors around the globe. The downside of this globalization of capital was felt when the U.S. markets began to stumble and eroded international investor confidence in the capital markets. As a result, liquidity has tightened globally and all types of debt have been impacted. This lack of liquidity is a result of the perception of risk, leading to repricing, as well as tightening due to losses.

Emerging mortgage market lenders that are more linked to global capital markets have seen their funding (especially long term) become more scarce and expensive. This could force lenders in these countries to take more conservative lending decisions. Those less dependent on international capital markets may be better off, including MFIs. Capital markets for MFIs are less developed, and the informal sector borrowers typically weather these storms better.

MAYBE: Multiple Investment Officers, FMO

What we notice is that fear has arisen to invest in the housing sector. In our opinion this fear is not always justified. Our clients put a lot of emphasis on affordability. Only people who have an income, or a track record, can apply for a loan. The loan amount is based on a sound loan-to-income ratio and often people have to make a 10 to 20 percent down payment. This reduces the risks. Still, we see that local banks suffer from the negative sentiment, which affects their funding capabilities. The appetite for investing has decreased and funding has become scarce. Funding is becoming more expensive, resulting in more expensive mortgages. Affordability is becoming an even bigger issue than it already is. Countries that depend on international markets are most vulnerable. Some banks use repayments to meet their own obligations and are no longer able to lend money. One consequence is that developers lack access to funding, which has an impact on the availability of affordable housing.

Some of our respondents had a bit more to add on this matter—see their extended responses below:

Lauren Moser's extended response:

The subprime mortgage crisis, which manifested itself during the summer of 2007, had its roots in mortgage markets being opened up to a wider swath of borrowers than ever before, fueled by lower interest rates, rising property values, and imprudently aggressive lending tactics. Many mortgage originators convinced themselves of a new paradigm where property values always went up and interest-only, reverse amortization, and 100% LTV (and beyond) were the norm. As interest rates began to go up, and adjustable rate mortgages began to reset to higher rates, many of these borrowers could no longer handle their payments. The Mortgage Bankers Association (MBA) fourth quarter 2007 home mortgage and delinquency data released March 6th reveal problems continue to worsen in the U.S. market. The national delinquency rate for all mortgages past due 30 days or more climbed to 5.82% from 4.95% a year earlier, which is the highest in 22 years. Subprime delinquency rose to an unprecedented 17.31%. At the same time, more than 2% of mortgages are in foreclosure, the highest percentage by far since the MBA began counting in 1979, with 13.43% of subprime loans nationally in foreclosure. For its part, ShoreBank, a community development bank and ShoreBank International affiliate operating out of Chicago, Cleveland, and Detroit, has launched a Rescue Loan Program for those otherwise creditworthy borrowers who were sucked into untenable adjustable rate mortgages by teaser introductory rates. These fixed rate 30-year mortgages offer some relief to individuals in these communities, where serious subprime delinquencies are 22% in Illinois and as high as 28% in Michigan, while foreclosures are 15.8% and 17%, respectively.

Over the past several years, mortgages have become a commodity, with lenders selling off huge volumes of portfolios in the form of collateralized debt obligations (CDOs) to fuel portfolio growth. These CDOs were purchased by investors as far as Asia and the Middle East. The sellers of these CDOs had access to world markets to fund more loans and the investors reaped the financial benefits of the global economy with growing returns.

The downside of this globalization of capital was felt when the U.S. markets began to stumble. International investors across the world have experienced substantial real portfolio losses. HSBC, BNP Paribas, Merrill Lynch, Commerbank, Credit Suisse and many others across Europe and Asia have all reported losses for 2007 in the billions due to their portfolio holdings. This has eroded investor confidence in the capital markets. According to Standard and Poor's, global losses across stock markets totaled $5.2 trillion in January resulting from double digit drops in the local stock markets such as Turkey (22.7%), Russia (16.1%), and India (16%), among others. As a result, liquidity has tightened in international capital markets and all types of debt have been impacted. This lack of liquidity is a result of the perception of risk, leading to repricing, as well as tightening due to losses.

What does this mean for local mortgage markets across the world? In places that have successfully tapped into global markets, like Russia, Mexico and the United Kingdom, funding for mortgage lenders has become more expensive and long-term funding has been harder to raise on the international market. This could force lenders in these countries to grow at a slower pace, take more conservative lending decisions, and it could also force some consolidation in the industry. This may not be such a bad thing.

Those countries whose markets are less exposed to globalization because their mortgage markets are not as developed may in fact be better off at this stage. Local liquidity by most accounts is still strong. However the availability of long-term funding to fund long-term loans in local markets has typically been a problem. In terms of microfinance for housing, given these loans are not secured by a home mortgage, but alternative forms of collateral, the secondary market for these portfolios is not as well developed and therefore is not as dependent on international capital markets for growth. In fact these informal markets typically weather global financial contagion well – as has been the case in places like Mexico. International financial institutions, donors, and local capital markets could benefit from the opportunity of a global liquidity crunch by stepping in when funding is scarce to help grow these emerging sectors.

For those of us providing technical assistance to housing loan originators in emerging markets, the subprime mortgage crisis in the U.S. gives us the opportunity to reiterate the importance of the fundamentals of loan underwriting, standardization of lending policies and processes, portfolio management, and knowing your borrower. In the end these portfolios are only as solid as the lending decisions behind each loan. Even credit scoring – which can bring about efficiencies for the loan originator -- only try to mimic what an experienced lender would do. We do not benefit our borrowers by making loans which they cannot afford, which continues to be played out in the lives of those going through foreclosure in the U.S.

FMO's extended response:

It is our experience that the impact of the US housing market meltdown varies from region to region and even from country to country. The impact depends on a number of factors including: the housing markets' maturity, the dependence on international markets, the local banks' performance and risk policies and also on government regulation. Although we have to be careful in drawing conclusions and have to look at this question on a case by case basis, we do see evidence that the crisis in the US is having a negative impact on some markets.

One common feature in many markets is that fear has arisen to invest in the housing sector. In our opinion this fear is not always justified. In most of the markets where we invest, for example in Central America, our clients put a lot of emphasis on affordability. This means that only people who have an income, or a proven track record, can apply for a mortgage or housing micro loan. The loan amount is based on a sound loan-to-income ratio and often they have to make a down payment of between 10 and 20 percent. This significantly reduces the risks. In this sense, these markets are less vulnerable to a similar crisis.

By providing mortgages to people with stable incomes with a conservative loan-to-value ratio the mortgage sector in Central America distinguishes itself from the US market where mortgages have been provided to NINJas (No Income No Job) with teaser rates. These rates are low in the beginning but increase significantly over time which makes the mortgage impossible to service. This phenomenon has been a result of cut throat competition in a saturated market. In Central America this is not yet the case as the market still shows a robust penetration growth. In Asia, most banks are also quite careful in their lending activities. The use of low cost-to-income ratios and low loan-to-income ratios ensure that this market is protected against a housing market crisis. The majority of local banks have not invested in American high risk mortgage markets. This, combined with the fact that Asian markets are generally characterized by strong economic growth, limits the impact on the local economy.

In some countries, however, we do see that local banks and housing institutions clearly suffer from the negative sentiment. This affects their funding capabilities. The appetite for investing in emerging markets has decreased and funding has become scarce. Consequently, funding is becoming more expensive, resulting in more expensive mortgages. Affordability is becoming an even bigger issue than it already is. Investors have less appetite for securitizations. Maturity mismatches pose a threat. This situation asks for support from development financial institutions (DFIs), such as FMO. DFIs need to perform their development mandate in circumstances where development is most needed.

Experiences in Eastern Europe and Central Asia are mixed. Countries such as Russia and the Ukraine do not depend on the international market for funding. In those countries, we have not (yet) seen proof that there is an impact on the housing markets. However, countries that depend on international markets are much more vulnerable and there the impact is much more severe. Some banks are no longer able to lend money to their clients and use repayments to meet their own financial obligations. Moreover, the lack of funding for banks has led to problems in the construction sector. Developers lack access to finance to build houses. In some instances, the houses have been partly built, but developers lack the means to finish them. There are people who already paid for these houses. This could have an impact on other sectors of the economy. However, governments have provided their support, and good regulation can prevent a lot of problems.

In Africa, excluding South Africa, we see another picture. Due to the incipient stage of most housing markets in Africa, the US housing market meltdown has less impact than in more matured housing markets. Even though housing is high on political agendas across the continent, the development of housing and housing finance markets in Africa are still in a nascent stage. Both the demand and supply side of housing face considerable structural impediments (regulatory, land ownership, judicial). This constrains the development of the mortgage market. So far, commercial banks, to the extent that they are engaging in mortgage finance, do so on the back of usually short term funding from saving accounts and short term deposits, that, while adhering to prudent (regulatory) guidelines, limits the growth of their asset book and impacts the mortgage product design (tenors). Banks are generally incentivized to enter mortgage finance as reducing interest levels in most countries in Africa drive bank liquidity out of previously high rewarding treasury bills. Developing niches in the retail market has become a clear trend and in particular mortgage finance is receiving a lot of interest these days. By and large however, Africa is a primary mortgage market with no secondary mortgage market activities on any meaningful scale. Term funding is scarce, partly because of only early stages of liberalization of pension schemes.

There is also a shortage of appropriate funding for housing supply as the established banks tend to shy away from the perceived high risk profile associated with this business. The lack of a track record, and proper experience and capacity to develop large scale projects, limits housing projects typically to small and medium sized projects of several tens of units. Hence, informal and incremental housing still account for a large part of housing activity in Africa. This picture has not undergone any change as a result of the sub-prime crisis.