Press Points for Chapter Three:

Housing Finance and Financial Stability—Back to Basics?

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Key Points

- To avoid future housing bubbles, policymakers should take into account best practices for creating and maintaining stable housing finance systems. Our empirical analysis points to three broad areas of best practice:

    1) Policymakers should focus on the health of the mortgage origination business by encouraging enhanced risk management, better underwriting standards, and effective supervision.

    2) Government participation in housing finance needs to be more carefully considered to avoid unintended consequences. Empirical analyses point to the significant financial stability impact of government participation in the run-up to the recent crisis.

    3) Incentives in the private-label securitization business, including mortgage servicing, need to be better aligned with those of investors.

- Countries seeking to create new housing finance systems should start by encouraging solid regulation, effective supervision, and transparency. This is particularly relevant for a number of emerging market countries, where policymakers have more leeway to determine the underpinnings of their housing finance systems.

- The U.S. housing finance system, which has several unique features, needs to be reformed. We welcome the recent reform proposal by the U.S. administration.

This chapter analyzes housing finance systems in a number of representative advanced and emerging economies in order to identify factors that enhance the stability of housing finance systems, and financial stability more generally. It is important to note that the financial stability impact of housing market meltdowns is greater in some countries than in others.

This is partly because of important differences in countries' housing finance systems, including the role of government.

In particular, this chapter examines aspects of housing finance systems in some advanced countries that contributed to financial instability during the recent crisis.

Empirical analyses in the chapter—across countries and over time—show a close correlation between rapid mortgage credit growth and sharp increases in house prices. It also examines the impact of a number of housing finance characteristics on mortgage credit and house prices. For example, government participation exacerbated house price swings and amplified mortgage credit growth in the run-up to the recent crisis, particularly in some advanced countries. On average, countries with more government involvement also experienced deeper house price declines.

Moreover, higher loan-to-value ratios are significantly correlated with higher house price and credit growth over time in advanced countries, in line with the findings of many other studies. This effect disappears when emerging economies are included in the sample covering the most recent period. This might be due to less formal loan limits in these countries, where unregulated sectors tend to play an important role in the lending process.

Three broad areas of best practices for stable housing finance systems emerge from the chapter: (1) enhanced risk management, better underwriting standards, and more effective supervision; (2) more careful calibration of government participation; and (3) better alignment of incentives in the private-label securitization business with those of investors.

The chapter discusses additional aspects of best practice that need to be considered by policymakers in emerging market countries, as they set up their housing finance systems. In particular, to focus first on developing solid regulation and oversight for all organizations originating loans so as to help ensure good underwriting standards. Credit bureaus that help educate consumers about the nature and risks of mortgage products are also important.

Finally, based on the best practices, the chapter makes specific recommendations for the housing finance system in the United States. This system remains unique in many ways, and an overhaul is needed. The U.S. administration's recently-released housing finance reform proposal is a welcome step in the right direction.

Reform of the U.S. housing finance system should address current gaps in the regulatory, supervisory, and consumer protection frameworks. It should aim for better-defined and more transparent government involvement in the housing market, showing relevant items on the government's budget. It should also reconsider the role of the housing-related government-sponsored enterprises, given the need to create a more level playing field in mortgage markets. Finally, the reform should encourage "safe" private-label securitization, including by improving the alignment of incentives. Such reforms would have a significant positive effect on the U.S. financial system and would help bolster global financial stability.