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Housing Finance Systems That Can Weather Storms

By Singapore Management University |Editorials
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Resilient housing finance systems are crucial for global economic stability and to solve housing affordability problems in both developed and emerging economies, says SMU Professor Phang Sock Yong.

AsianScientist (Dec. 23, 2013) – By Prime Sarmiento – Developing resilient housing finance systems will not only prevent another subprime mortgage crisis that crippled the US economy but also help solve urban housing affordability problems in both developed and emerging economies, says Phang Sock Yong, Professor of Economics at the Singapore Management University (SMU) School of Economics.

“A well-functioning housing finance system fulfils multiple objectives – promoting social and political stability, enhancing housing market performance, as well as contributing to financial sector stability and development,” she says.

Professor Phang, who has researched and written on housing economics extensively for more than two decades, is the author of the new book *Housing Finance Systems: Market Failures and Government Failures* (Palgrave Macmillan, 2013).

The state’s role in the housing sector
“Numerous housing market failures provide justification for government intervention in housing finance systems to facilitate the flow of resources into the housing sector,” says Professor Phang.

She says that state intervention is necessary to channel resources into housing and cope with the challenges brought by market failures, cross border capital flows, misaligned incentives and, paradoxically, regulatory failures.

State-owned enterprises are not necessarily better or worse than private companies, she says. In addition, she stresses that factors such as cultural norms and socio-political objectives of the government will determine the extent of state intervention and choice of housing policy framework for each country.

"In the discussion of appropriate institutional design, we need to recognise that the more important issue may not be the drawing of clear boundaries between market and government, but rather, the correct alignment of incentives within an organisation and its proper governance," she says.

There are several ways for policy makers to be involved in housing finance, says Professor Phang, such as by regulating mortgage instruments and financial institutions, and by establishing conduits for funding housing. Housing finance conduits include contractual savings schemes, provident fund savings, mortgage securitisation, covered bonds, liquidity facilities, real estate investment trusts and institutional funds.

Professor Phang has seen the success of state-run agencies such as Singapore's Housing and Development Board in providing homes for its citizens. Ninety percent of Singaporeans are now property owners – a feat that was accomplished because of the government's decision to become a home builder and to facilitate housing finance through the Central Provident Fund scheme.

"Housing is one of the most important items in a household's consumption basket and can have a major lifetime impact on a person's well-being. If a substantial segment of the population does not have resources to enable them to have access to affordable adequate housing, the resulting situation could be considered a housing crisis," she says.

What constitutes housing affordability, however, will depend on a particular market. The most common indicators used in measuring affordability are the rental expenditure to income ratio for rental housing and the ratio of median house price to median income for homeownership affordability. In addition, the latter needs to be supplemented by an indicator for mortgage affordability. Mortgage lenders usually set the maximum ratio of debt service at around 30 percent of the potential homeowner's income. Housing policies can have a major impact on mortgage affordability through regulations on mortgage products and housing finance institutions.

But a more holistic picture of housing affordability is needed, says Professor Phang.

"No single measure of housing affordability is adequate, and a basket of measures would be required to obtain a complete picture of housing affordability and correspondingly segments of households that could be facing a housing crisis."

Housing crises in developed and developing countries

In London, San Francisco and New York, many lower income households are facing an affordability crisis due to a shortage of low-priced affordable housing. This is in contrast to Singapore, where 90 percent of its population of more than three million are home owners. When a recent surge in population growth and global liquidity led to escalating house prices and threatened home affordability in Singapore, the government implemented direct measures to cool the housing market such as differentiated stamp duties, increased housing grants for first time home buyers, and ramped up housing supply.

In many developing economies, meanwhile, inadequate housing systems in the face of rapid urbanisation have led to squatter settlements and slums. Slums such as Dharavi in Mumbai, the Tower of David in Caracas and the now-closed Kowloon Walled City in Hong Kong are the more glaring examples of housing crises that beset developing countries.

"Images and stories from these housing crisis situations have come to epitomise the triumph of the human spirit over adversity. These, however, should not obfuscate the very real difficulties faced by the several thousands of people affected," she says.

In both developed and developing countries, housing crises may occur following a large-scale destruction of housing stock due to war or unexpected disasters such as fires, earthquakes, hurricanes or typhoons. Such is the case in Syria, Afghanistan, Haiti and the Philippines, which have recently suffered either wars or natural disasters and are now facing humanitarian crises which encompass, among other things, a severe housing shortage.

Cyclical booms and busts of the property market may also trigger housing crises. At the boom phase of the cycle when rents or prices are high, lower income segments of the population may face a 'housing affordability' crisis. Conversely, at the bust stage of the cycle, housing crises could take the form of mortgage delinquencies, high foreclosures and vacancy rates, and abandoned residential projects. The same factors that drive property cycles can lead to bubbles and crisis – with the 2007 US housing bubble burst igniting the global financial crisis of 2008-2009.

"The US housing crisis of 2008 had its roots in irresponsible mortgage lending to subprime borrowers," Professor Phang explains. "The increase in lending that fuels a bubble is not unique. Most real estate bubbles have in common easy access to low cost credit which stimulates demand and drives up prices. Many factors are often at work simultaneously to drive credit growth."

Transparency in housing finance systems

But more than the expansion of risky mortgages, Professor Phang believes that it was the complexity of the US mortgage backed securities markets and opaque interconnections of securitised finance that contributed to the 2008 crisis.

"A large proportion of increase in housing credit in the years prior to the crisis had taken place in the shadow banking system. This meant that no one understood what the securitised assets were worth and who owed what," she says.

The Harvard-trained economist says the 2008-2009 US subprime mortgage crisis provides many lessons for policymakers on the vulnerabilities of an overly complex housing finance system and the role of policy and regulatory failures. It also shows that governments could reduce uncertainty by providing relevant data and promoting a more transparent market. "Given the importance of data for understanding housing markets, the lack of reliable information can be a cause of market failure," she says.

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