

# **Social housing policies and the transformation of financial systems: Lessons for the European Union**

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## **Introduction**

In the course of numerous financial crises especially banking crises and increasing economic disparities between countries, the financial sector as well as national financial systems emerged as a vivid area of research. Using quantitative databases of the World Bank it turns out that market based financial systems tend to overbalance in highly developed economies. Simultaneously, financial fragility seems to increase in market based financial systems. When analyzing developments of national financial system with bank-based origins, transformation towards a more market based financial cannot be observed – although this is assumed by any economists (see for example the extensive analysis of Schaberg, 1999), basing on quantitative measurement of financial flows. Since quantitative assessments do not cover the full pictures of financial systems' evolution, qualitative criteria are introduced; mainly by corporate governance structures (see Zingales, 1997; Shleifer / Vishney, 1997). This paper aims first to introduce qualitative indicators on a macroeconomic level, by discussing the involved redirection and reduction of state responsibilities in housing sector policies, when financial system transformation occurs. When referring to state responsibilities for social security, the argument does not derive from potential shifts of financing which Eichengreen (1997) opposes when outlining evidence of decreasing individual tax burdens in OECD economies, but doubts the capability of citizens to deal with increased personal social responsibility.

Therefore the research question in this paper is two-folded: First, changes in housing sector policies of bank based financial systems are investigated, where special attention will be drawn to Austria, France and Sweden. The results are compared to the housing finance structure in the USA. The following research questions can be derived: Can shifts in social housing policies be detected and can they be quoted as qualitative indicators for a transformation towards a market-based financial system? Secondly, this enables the discussion of effects for financial stability and social security. Since increases in housing

prices could clearly be observed in the USA and house-ownership becomes more affordable while rentals are less affordable (Quigley / Raphael, 2004), a fact which leads to potential social deficits, the following second research question can be derived for this paper: Do price increases in the real estate sector lead to a mis-performance of public housing subsidies schemes by not fulfilling the proclaimed social aim? From this analysis, policy recommendation for financial sector stability and social housing policies in the European Union are derived in the final part of the paper.

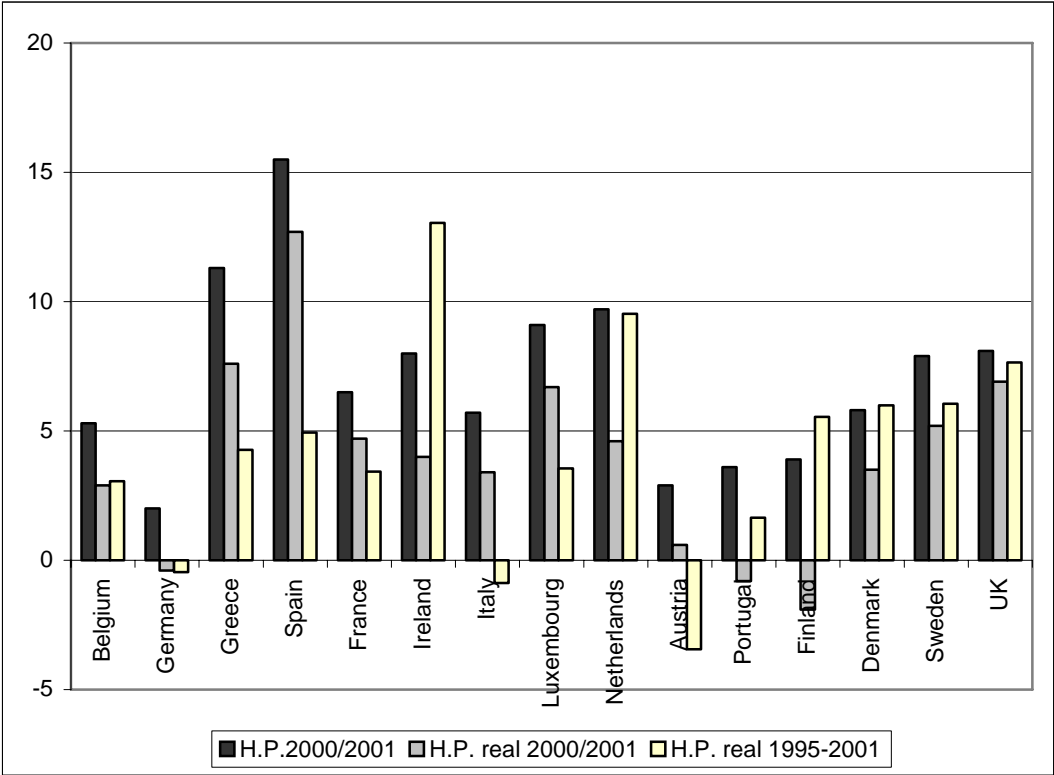
The paper proceeds as follows: After introducing some stylized facts on international housing market developments, linkages between national financial systems and housing finance systems are investigated. Cases for housing financial markets with a stronger market and stronger state approach are compared with housing price developments. In part three and four the relation between social aims – in terms of affordability housing and economic wealth of households – is investigated.

## **1. Stylized Facts on Housing Markets Developments**

In the last years housing markets were characterized by substantial price increases. As graph 1 shows housing price increases vary substantially across countries and time. Spain shows with 12.7% the strongest price increase when looking at the real numbers 2000/2001, whereas in Finland real prices even decreased by 1.9% in the same period. When looking at the real price increases from 1995-2001 similar spreads across countries can be observed. In this case Ireland has with 13.05% the highest rise and Austria with 3.44% the highest decrease. When taking the whole boom phases in housing prices of various European Countries into account increases of up to 243% (Ireland between 1992-2005) can be observed. This number is followed by the developments in the Netherlands (1985-2005), the UK (1995-2005) and Spain (1996-2005), which noticed an increase of 183%, 137% and 114%. (RICS, 2006:9)

Despite of different slightly changes results when looking at different time horizons distinctive blocs of countries can be distinguished. Germany, Austria, Portugal and Finland can be classified as economies stable housing prices, whereas the UK, Ireland, the Netherlands, Greece and Spain show strong increases in housing prices; although the price performance varies with the observed time horizon. The UK, Netherlands and Ireland show high increases from the 1995 onwards, whereas housing prices faced a strong increase in Greece and Spain only in the 2000/2001.

Graph 1: Developments in Housing prices in EU15



Source: ECB, 2003; Czerny / Wagner, 2003

Simultaneously to these developments in housing prices also major changes in housing market could be observed. These trends were partly promoted by changes in European demographic structures, socio-economic changes – which in turn had an influences on housing market demand especially the decreasing number of household members – and overall macroeconomic indicators, like the need to reduce public debt and deficit ratio to fulfils the Maastricht criteria, which required in turn a decrease in public spending and lower volumes of housing subsidy programs to fulfil social aims (see among others Czerny, 2001; Springler 2005). Additionally the liberalization of credit markets also had an important influence on housing finance structure, which followed the model of the US housing finance structure and focused on strengthening secondary mortgage markets and the implementation of innovative housing finance products.

In the US the development of secondary markets in the housing finance sector emerged already in the 80s and reached a remarkable volume in the mid 90s. As Colton (2002:8) describes, seeds for innovative products on the housing sector were led in the late 60s with the division of the Federal National Mortgage Association into two entities, Fannie Mae and

Ginnie Mae; the purpose of the latter was to guarantee *mortgage backed securities*<sup>1</sup> insured by the Federal Housing Administration and the Veterans Association and issued by Fannie Mae. Nowadays the US housing finance system has experienced further diversification in mortgage backed securities, which include the increasing importance of issues by so called Non-Agencies, which in contrast to the government-sponsored enterprises Freddy Mac and Fannie Mae do not only give, concentrate to give mortgages to not-prime debtors (households) (Colton 2002:18; Florida 1986:xiii; Frankel 2006:76). The total volume of mortgage backed securities increase in the 90s constantly and reached 2005 2.9 billion US dollar. The ratio of Non-Agencies increased even stronger in the last years and accounts 2005 for more than 75% of total volume; in the year 2001 their ratio was below 50% of total mortgage backed securities issued (Frankel 2006:77). Despite the increasing possibilities of lower income households to become house owner – which was of course one main argument in the US to promote innovative housing finance product<sup>2</sup> - these developments are connected to increasing risk of default for lower income households (Debelle 2004:59) as can be see when looking at the increasing household debt to asset ratio.

Table 1: Share of European Securitization Market in %, 2003

Country	Share of European Securitization Market 2003 in %
UK	35
Spain	17
Italy	16
Netherlands	10
Portugal	5
France	3
Sweden	2.5
Other countries	11.5

Source: Suarez / Vassallo 2004:48

Compared to these developments the situation in Europe is far not that elaborated. Out of the Member States of the European Union the secondary housing finance market in the UK is by far most developed and accounts for 47% of total residential mortgage backed securities in

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<sup>1</sup> Using this instrument of securitisation a bank or other finance company sells loans to an independent company for cash payment. The company in turn issues bonds to investors and uses the proceeds from the sale to purchase the loan from the original creditor. Repayment of the loan is used to redeem the bond. Several forms of mortgage backed securities exist, like residential mortgage backed securities or commercial mortgage backed securities (see Committee on the Global Financial System 2006: Box 3 p.15). Mortgage backed securities differ from Mortgage bonds (Pfandbriefe), which have been extensively used in many European Economies also before the recent boom in secondary housing finance markets (see for more detail Suarez / Vassallo 2004: 44)

<sup>2</sup> Another mayor argument was the improvement of possibilities to withdraw housing equity.

Europe - this amounts 18.4 billion Euro issuance in the first quarter 2006. (ESF 2006:2) Although with lower volume, similar trends towards secondary mortgages and sub-prime mortgage lending can be observed here (Miles 1994:38; Committee on the Global Financial System 2006: 16).

Comparing developments of increasing housing prices in European Economies from graph 1 with the share of European securitization Markets as described in table 1 it becomes evident that most countries with extensive use of securitization housing finance products also experienced a strong increase in house prices. Nevertheless there is no full correlation observable. Despite of the fact of simple introduction of securitization products also institutional and structural features of the housing finance system seem to be important to promote or hamper strong housing price increases. Basing on these empirical evidences, structural features of national finance systems and housing finance systems are elaborated.

## **2. National financial systems and housing finance systems**

When trying to classify national financial systems flow of funds for investment and firms' financing used to the starting point for economists (OECD, 1995:15; Allen and Gale, 2000). Although it turned out that this functional finance approach has its limits due to the minor importance for firms' financing, since the main source of finance are retained earnings (see among others Schaberg, 1999:20; Huffschnid, 1999: 18) it remained the main starting point for analysis. To different paths to deal with the consequences of the analysis of Schaberg and Huffschnid were drawn. On the one side economists like Corbett and Jenkinson, 1994:74 or Mayer, 1988 concluded that the classification has to be enriched by qualitative factors which aim to investigation the *relationship between creditor and debtor* in a national financial system. On the other side economists, especially those of the World Bank (Levine, Demirgüç-Kunt, Beck and others) developed a more sophisticated *data base* (Demirgüç-Kunt and Levine, 1999) as to measure not only flow of funds but also depth and efficiency by comparing volume and turnover of the banking sector and the stock exchange. Although the method introduced by economists of the World Bank suffers from strong sample dependency it can serve as a first step to grasp the financial flow of funds interrelations between banks based and market based economies. When additionally looking for example at the methods of banking regulation to account for the qualitative factors a better overview over different national financial systems can be given. It can be shown (Springler 2005b) that in developed

economies qualitative and quantitative characteristics of financial systems (market based or bank based) simultaneously aim to promote higher short term / or long term growth and enable more / less innovation by less / more rigid institutional frameworks, which in turn promote a lower or higher degree of stability.

Basing on this analysis this paper states that similar to the distinction into national financial system for financing investment project of firms, different financing systems for durable consumption goods of households – housing – can be distinguished. Similar to the findings of analysis in national financial systems table 2 distinguished between bank-based and market-based housing finance systems by introducing quantitative and qualitative indicators.

Table 2: National financial systems and housing finance

	<b>Bank Based</b>		<b>Market-Based</b>	
	<b>Financial System</b>	<b>Housing System</b>	<b>Financial System</b>	<b>Housing System</b>
<b>Financing</b>	Credit	Mortgage	Stock Exchange	securitization products
<b>Relation creditor /debtor</b>	tight	tight	loose	loose
<b>Time horizon</b>	Long term	Long term / housing	Short term / shareholder value	Short term / liquidity
<b>Regulatory regime</b>	Protective banking reg.	Primary social goal / strong state interference	Preventive banking reg.	Ownership society / strong market mech.

The primary source of financing investment projects serves as starting point for quantitative measurement. The criteria *financing* will be a dummy variable for a so called “structure index”, which will be explained in more detail when analyzing the different housing systems and follows the methodical approaches of the world bank in conducting a more sophisticated data base on roots of financing by distinguishing between size, volume and efficiency of the banking sector compared to the stock exchange in a respective country. Similarly the indicator financing resembles the focus of housing finance systems on mortgages or secondary market instruments like asset backed securities. Although the main actor in this case the household does not actively aim to use securitization instruments limited or excessively shows the importance of the stock exchange. The quantitative criterion of financing is amended by several qualitative criteria which represent the institutional and structural framework of the housing finance sector. The *relation between creditor and debtor*, that can be rather tight or loose helps to understand how the individual household is seen in the system. In case of a tight relation, which is the case in a bank based national finance system or housing finance

system changes in the loan contract might be added in case of illiquidity of the household or changes in the overall wealth position. In case of a loose relationship, there might be less intention to discuss alterations in the contract. The existence of tight or loose creditor / debtor relations emerges immediately out of the quantitative analysis of the volume, size and efficiency of the housing finance system. Another qualitative criteria is the *time horizon* of the system, similar to the respective characteristic of bank based and market based financial systems also the housing finance system might be settled in a long term or short term institutional framework (see table 2). A quantitative measurement to grasp this qualitative factor might be the amount of equity withdrawals in a system, which are not used to housing purposes. The *regulatory regime* is a further important qualitative indicator for a rather bank based or market based financial system. This criterion emerges from banking theory to explain differences in regulatory methods between bank based and market based financial system and aims to show the strength and directness of state intervention on the national financial system (Bernet, 2003). Preventive and protective measures can be distinguished then looking at different regulatory frameworks. Protective measures would imply a stronger and more direct interference of the state with the financial structure, whereas preventive measures would focus on self-regulatory market mechanisms for regulation and therefore resemble a market based financial system. In the case of housing systems the volume and structure of state subsidy programmes, which the aim of either promoting an ownership society or promoting affordable housing seems to be the major difference between bank based and market based housing finance systems. The influence of the state can therefore be measured in quantitative terms by introducing to ratios, first of all the general volume of housing subsidy programs measured by the GDP shows the degree of interference of the state with market mechanisms. Furthermore the question arises whether an ownership society or affordable housing is the primary goal of state intervention. Therefore the volume of subsidy programs spend on so called objective-measures<sup>3</sup> is distinguished from subjective-programs. The indicator is conducted as volume of objective measures by GDP divided by the volume of subjective-measures by GDP. The bigger the result the stronger are objective measures and therefore the aim to create affordable housing, which leads to a bank based housing finance system.

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<sup>3</sup> Objective-measures of housing subsidy programs are spent to construct new dwellings or renovate existing housing units at lower costs, which enable the sell or renting of these housing units at lower prices. Subjective measures are conversely given to a household, which mostly has to meet certain income requirements or additionally requirements of family status to enable primary homeownership.

Basing on these definitions the following hypotheses will be derived from table 2 for this paper:

Housing finance systems have different effects on housing prices and affordability. Housing finance systems which resemble in qualitative *and* quantitative terms *bank based financial systems* hamper strong housing price increases and fulfil their aim of social protection and affordable housing. Housing finance systems which resemble in qualitative and quantitative terms market based financial systems force strong housing price increases. Due to high prices and a weaker institutional framework housing is less affordable; since the primary goal of market based housing systems is to increase the ownership society, the fact of less affordable housing cannot be quoted as mis-performance of the system. Only the simultaneous existence of low rates of homeownership, high household debt and high rates of homelessness could be raised as arguments of a mis-performance of the system. If qualitative and quantitative indicators do not show the same characteristic, but contain bank based *and* market based factors high housing prices and mis-performance of public goals will be the result.

#### Measurement of quantitative indicators

#### Measurement of qualitative indicators

3. Housing prices and the monetary transmission process

4. Changes in affordability: Misperformance of housing subsidy systems

Conclusion

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## Appendix

Table 1.0

Country Name	Banks vs. Capitalization	Bank Credit vs. Trading	Trading vs. Overhead	Index	Financial System
Austria	3,86	8,53	-16,33	-3,93	bank
Belgium	-0,12	1,18	-13,23	-12,17	bank
Denmark	-0,41	-1,93	-10,78	-13,12	bank
Finland	-1,16	-2,50	8,06	4,41	market
France	-0,56	-1,81	-8,20	-10,57	bank
Germany	1,48	-0,61	-7,62	-6,76	bank
Greece	-0,21	-2,61	-8,33	-11,15	bank
Ireland	0,43	-0,28	20,97	21,12	market
Italy	0,18	-1,32	-11,85	-12,99	bank
Luxembourg	-1,52	12,70	-15,09	-3,91	bank
Netherlands	-0,98	-2,88	58,50	54,64	market
Norway	0,45	-1,03	-8,06	-8,64	bank
Portugal	0,80	0,56	-9,82	-8,46	bank
Spain	-0,05	-2,54	5,64	3,04	market
Sweden	-1,24	-3,19	14,52	10,09	market
United Kingdom	-0,93	-2,24	9,16	5,99	market
			<b>Mean</b>	<b>0,47</b>	

Datasource: World Bank Data Set, own calculations

Table 1.1.

Country	Introduction of Securitization (MBS, RMBS)	Use of Securitization
Austria	--	no
Belgium	yes	limited
Denmark		
Germany		Yes??
Greece		
Spain	1992	limited
France	1999	limited
Ireland	Second half 1990s	
Italy	yes	extensive
Luxembourg	yes	yes
Netherlands	yes	extensive
Portugal	yes	limited
Finland	1989	
Sweden	yes	limited
UK	1987	extensive

Source: ECB 2006; Suarez / Vassallo 2004.