

Crisis on the American Mortgage Market – Lesson for Poland.

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Replying to the frequently asked question: “will the credit crisis in USA and Western Europe hit Poland,” I say: “there is no need, we can make it happen ourselves.”

The source of the present credit crunch in the US and some EU countries is the mechanism by which mortgage banking has expanded, which has generated various erroneous premises underlying risk management, mainly as the result of revaluing safety nets.

In a period financial market globalisation, the main channel of spreading a credit crises beyond credit institutions is securitisation of mortgage credits. This has trans-sector and trans-border results, depending on the scale and structure of the buyers’ market in MBS (*Mortgage Backed Securities*), CDO (*Collateralised Debt Obligations*), as well as Letters of Pledge (from the German *Pfandbriefe*) and SIV (*Structured Investment Vehicles*).

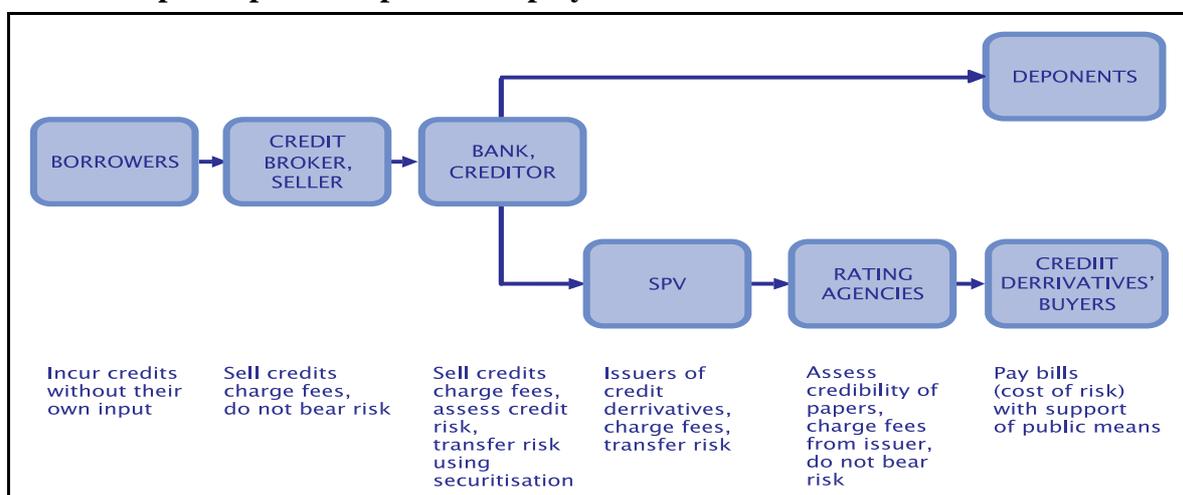
Through the global market in derivative credit instruments the credit crisis also reaches insurance institutions, investment funds, investment banks and others whose area of specialisation is not managing credit risk. What is more, the sources and the consequences of the crisis appear in various countries.

From the role of risk managing institutions, banks have grown into intermediaries transferring risk to other market players. Do such banks continue to be credit institutions?

The characteristic feature of the current credit granting process is avoiding credit risk for the majority of the financial market. Increasing competition drives creditors to offer mortgages without the due security i.e. higher than the value of the purchased real estate. At the moment of granting credit without “own input,” the creditor does not bear any risk. The credit seller who is an intermediary or a bank employee is usually rewarded according to the progressive piecework formula (the more credits they sell, the more commission they earn). They do not bear any credit risk either. Credit risk is at this time borne by the creditor and possibly an insurer. Increasingly often creditors transfer risk to other market participants, taking advantage of securitisation. In this risk-transferring process fees are charged by SPV, rating agencies and investment banks, although they still avoid risk. As a result, the costs of credit risk fall on investors who buy credit derivatives and in the case of no securitisation on banks and their clients. This process is illustrated by fig. 1.

Fig. 1

Credit risk participation of particular players on the financial market



Source: Author's own work

In this process there are at least three elements generating credit risk.

Firstly, at the moment of making a credit decision, accumulated borrower non-perception of risk can be combined with seller impunity.

Secondly, securitisation may not only lead to credit risk transfer, but also to banks' loss of interest in long-term credit policy, credit administration and collection and possible restructuring.

Thirdly, a conflict of interest in the rating agencies rewarded by issuers and lacking transparency and supervision increases the risk of loss of trust between credit market players.

What lessons for Poland?

The Polish mortgage market is small and inadequate in relation to the country's demographic and economic potential. It suffices to observe that in 2006 the share of the Polish population in the total EU population was 8.3%, while its GDP was 2.4% and its mortgage market a mere 0.03 %. Mortgages are in their initial phase of development, which can be best illustrated by the ratio of mortgages to GDP in Poland at 10%, against an EU average of about 50% and the US's approximately 75%. The Polish mortgage market has a national character and is not directly tied into the international mortgage financing market. As a consequence, there is no justification in limiting the development of this market in Poland in the wake of the turbulence on the mortgage markets in the US and some EU countries given that the risk of "infecting" the Polish market by the US crisis is small.

There are, however, other reasons to recommend monitoring the mechanisms by which national banks expand their credit portfolios in order to avoid uncontrolled fluctuations and perhaps also a banking crisis. The mechanism for credit expansion in Poland is analogous to the mechanism that is currently causing crisis situations in many countries. This is why a scenario for taking regulatory and supervisory steps has to be devised as soon as possible, in order to avoid a situation in which credit expansion mechanisms give way to crisis mechanisms. Observing the processes on financial markets struggling with cash flow crises, as well as the risk of loss of reputation and the symptoms of moral hazard, one can learn from the lesson of others' experiences and also learn from our own mistakes. Tomorrow it could be too late.

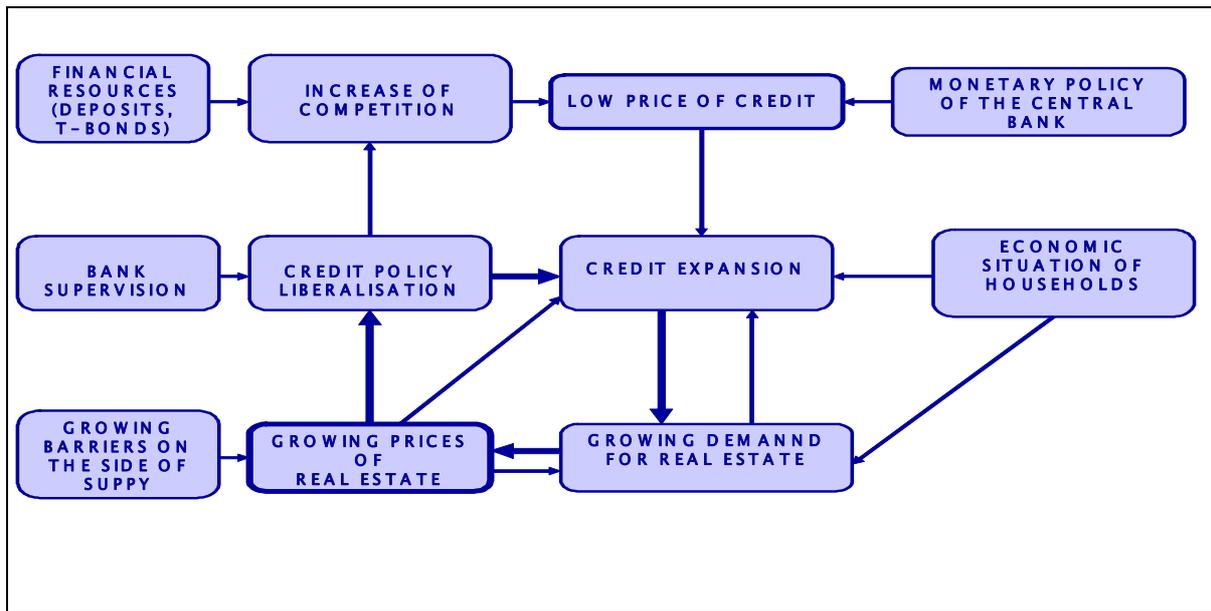
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Recent years have witnessed uninterrupted growth in the US and European mortgage markets. Such rapid growth has mainly been fuelled by:

- Low interest rates,
- Increasing credit availability,
- Growing property prices.

The following set off a classic credit expansion mechanism (presented in Fig.2): the low price of mortgages and banks' increased credit sales stimulate a rise in demand for flats and property prices increase. The increase in property prices, i.e. the value of the mortgaged security, allows banks to free up their credit policies and availability. This, in turn, results in a surge in demand for flats and a further rise in prices. The increase in property prices in turn additionally stimulates demand for credit, as borrowers – witnessing inflationary pressures on the housing market – witness any delay in house purchasing decisions reflected in immediately measurable losses for household budgets.

Fig. 2
Credit expansion and galloping inflation on the property market



Source: Author's own work

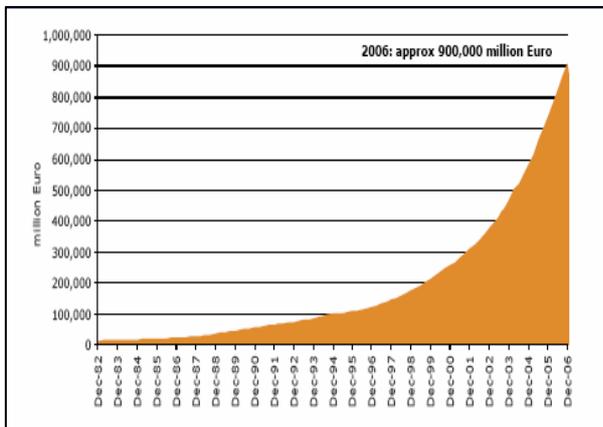
Banks create cash for credit faster than the increase in the value of the property offered for sale. The real estate market thus experiences typical demand-driven inflation (credit driven). The price of property is, furthermore, not part of the Consumer Price Index (CPI), the most popular measure of inflation, and does not impact directly on the inflationary targets of monetary policy.

Leaving aside the academic discussion as to whether homes are consumption goods or capital investment, it is worth noting that inflation on the property market can be characterised as “galloping” (double-digit price increases) and stems mainly from a derivative growth in mortgage lending. This situation occurs in many countries, Poland included. As a result of “galloping” inflation on the property market, borrowers take increasingly higher amounts of credit, often bordering on financial insolvency.

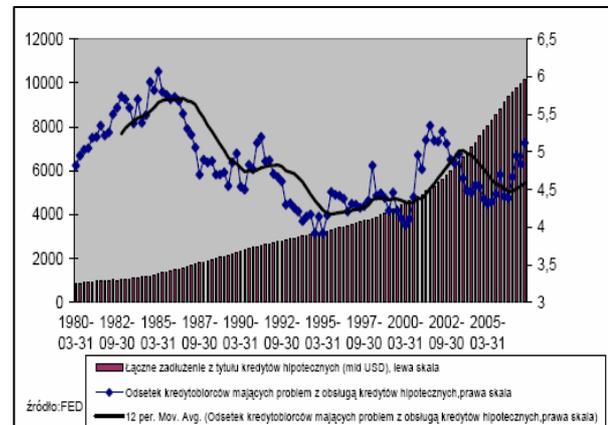
Such a credit expansion mechanism gathers further momentum because regulators and creditors then perceive credit risk via the growing prices of mortgage securities and the circle of creditors expands as a result of “galloping” inflation on the property market, accompanied by stable and low interest rates on mortgages. Borrowers’ monthly mortgage obligations change at a slower pace than the prices of flats because the credit period tends to become extended until perpetuity (*reverse mortgage*). As a consequence, credit expansion is characterised by an interpretative growth trend until it reaches crisis point (see Fig. 3).

Fig. 3
The interpretative trend of mortgage growth in Spain, the US and Poland.

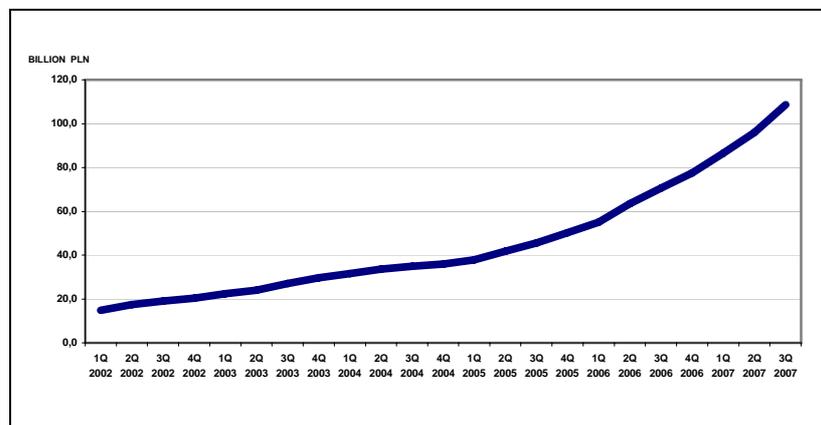
Spain, 1982 – 2006



USA, 1980 – 2005



Poland, 2002 – 2007 (3rd Quarter)



Source: Spain: *3rd Quarter 2006 Statistics*, European Mortgage Federation, February 2007,
 USA: FED [after:] *Ocena jakości kredytów mieszkaniowych i gotówkowych w Polsce na tle rynku amerykańskiego*, Expander's and BIK SA Report, Warsaw 23 October 2007,
 Poland: NBP (National Bank of Poland).

The interpretative pace of mortgage expansion, and accompanying inflation on the property market, will sooner or later lead to a situation in which borrowers will not be able to repay their mortgage rates.

There are two trends (processes) which differentiate the current credit expansion mechanism at the turn of 20th and 21st centuries from similar earlier phenomena, illustrating that the scope of any possible crisis can be much wider and the adjustment period much longer:

- 1) Automation of mortgage factories and outsourcing of mortgage sales;
- 2) Securitisation of mortgages.

Ad.1 Automation of mortgage factories and outsourcing of mortgage sales

The growing scale of credit activity tied to financing house buying has enabled - and forced - banks to automate mortgage services. The necessary condition of automation is risk management centralisation. Scoring automates have become widespread in this field, until recently only used for consumer credits, instalment plans and credit cards. Processes of granting mortgages are now undergoing centralisation.

Overall, risk management centralisation and credit process automation - combined with outsourcing of sales – means that a direct mortgage provider is not sufficiently tied to credit risk. The ad hoc system of rewarding credit sales generates operational risk that is difficult to foresee at present. Banks entering the market push up rates paid to credit intermediaries (currently at 2–2.5% of the value of the granted credit), which encourages competition, which in turn drives some market players to attempt to bypass the safe rules of credit policy. Client loyalty thus wanes and the refinancing wave of already granted credits increases and is undertaken by the most expansive creditors. The phenomenon of moral hazard is growing in popularity. A flagrant symptom of it is “piecework” credit sales without even a minimal contribution from borrowers.

The outsourcing of credit sales, the piecework remuneration system for sales and the avoidance of safe credit policy rules are also common on the Polish credit market.

Ad.2 Securitisation of mortgages

Despite the advantages of securitisation, the current credit crisis has showed that it does generate some circumstances that contradict its goals. Even if securitisation is in its infancy on the Polish financial market it is already worth pointing to the risk it entails.

Firstly, securitisation of mortgages has become a key channel for spreading crises outside the circle of creditors and borrowers. It has increased system risk on financial markets, not reduced it.

Secondly, credit risk transfers from credit institution to buyers of MBS, i.e. mainly investment funds and insurance institutions, **have driven the banks to neglect the quality of their credit portfolio** as they are no longer responsible for the risk, which is spread across investors from all over the world, and by reducing credit risk banks have begun carelessly stimulating sales of zero-contribution credits and cut back on diligent credit checks. It is estimated that over half of all credits granted in the US between 2005 and 2007 are in this category.

Thirdly, securitisation of mortgages has stimulated moral hazard and this in turn means the whole chain of intermediaries earning on commission also do not bear credit risk. Credit brokers and multi-brokers such as banks try to maximise their revenues by selling credits and then changing them into Mortgage Backed Securities (MBS). Then investment banks charge fees on changing MBS into *Collateralised Debt Obligations (CDO)*. Additionally, ratings agencies experience a conflict of interest because they charge fees from companies (*SPV – Special Purpose Vehicle*) transferring credit risk. Observing the increase in property prices, investors easily buy MBS and CDO, placing their trust in the professional ratings, although it seems evident that an adequate valuation of these complex and non-transferable instruments is nigh on impossible.

Fourthly, securitisation has diminished the transparency of the financial market as the structure of MBS buyers becomes unknown, as does as the market value of the securities. On the *subprime* market in the US alone the volume of losses is estimated at \$50-200 billion, depending on the forecast scale of the drop in property prices. As a result, when it is not known who owns this debt, all the involved players’ credibility falls and as a consequence leads to borrowing difficulties, i.e. a liquidity crisis.

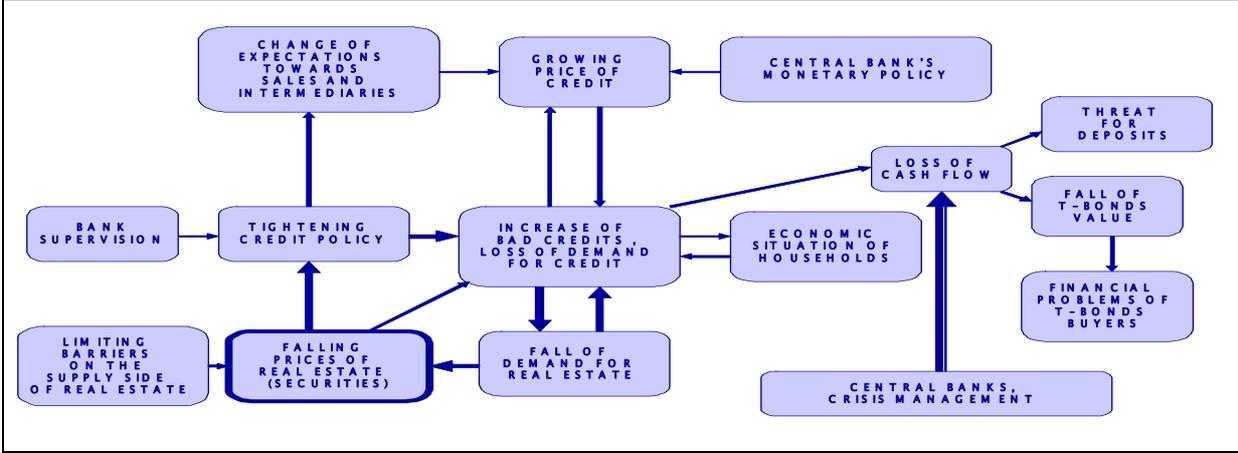
Securitisation of mortgages probably does not have direct consequences for the Polish financial market because it has practically no buyers or issuers of derivatives such as MBS or

CDO. This does not mean, however, that it will not see an indirect impact caused by turbulences on the global financial markets.

The biggest threat to the stability of the Polish financial sector is the mechanism of credit expansion analogous to that functioning in the countries undergoing credit crisis.

As the credit expansion mechanism slips out of control at a certain point it then transforms into a crisis mechanism. Protecting the financial system from a loss of stability then requires very expensive interventions by the central bank. The costs of crisis management are always incomparably higher than the costs of preventive actions. In the event of a banking crisis the costs reach over a dozen percent of GDP.

Fig. 4
The credit crisis mechanism.



Source: Author's own work

For national regulators and supervisors at the present stage of development of the mortgage market an answer to the following question becomes essential: whether and how to intervene in the credit expansion mechanism?

Should the uncontrolled and interpretative increase in mortgages, in combination with galloping inflation on the property market, be regulated by monetary policy instruments or by prudential-supervisory ones?

To date, the experience of countries that have felt the credit crisis indicates that the necessary caution was not observed. The fact that market players used moral hazard comes as no surprise given that the credit expansion mechanism tends to generate such actions. As a result we witness a situation where the banks of the countries in crisis - by pumping extra cash into the banking system - create value for shareholders because they do not allow a drop in the share prices of these institutions commensurate to the risks incurred. Despite the risk of inflation, they lower interest rates in order to prevent a fall in the market value of mortgage backed securities. Fearing the start of a crisis mechanism they allow for an increase in inflation. As a consequence we observe effects and actions that are contradictory to these intended.

Poland is in the initial phase of mortgage expansion. It seems that the currently moderate supervision and prudent steps will suffice to prevent more serious turbulence. These actions should be synchronised with economic and social policy and should focus on setting prices on the property market.

Property prices are the key element of the mortgage expansion mechanism, and – subsequently - also of the crisis mechanism. A rapid fall in property prices will make the

market value of mortgage-backed securities illusory, which constitutes a direct impulse for the mortgage expansion (mechanism) to turn into a crisis mechanism. Falling property prices then cause, on the one hand, a drop in credit demand, and on the other hand a tightening of banks' credit policies. If credit prices increase additionally during this time for instance as a result of a hike in interest rates or currency risk, then any plummeting of their prices becomes even more dramatic, in turn thus also deepening the difficulties in regaining control over the crisis.

The current situation on the mortgage market in Poland - which is in the first phase of increasing growth - still affords possibilities for taking effective preventive action to avoid any possible crisis situation. They require reducing the pace of inflation of property prices to single digits. Excessively restrictive regulations or actions could, however, cause a slump on the market as a result of a sudden fall of the value of securities and the crisis mechanism could kick-in.

This is why we need to take into consideration all factors shaping the property market in Poland. These are slightly different from those in countries like the US, Germany or Spain. Alongside the main reasons for an increase in mortgage demand, similar to the EU, i.e. low interest rates, freed up mortgage policies and an expected rise in property prices, Poland has some strongly specific conditions. These are primarily fundamental factors related to unsatisfied housing needs. For instance, the number of flats in Poland per 1,000 inhabitants is more than 30% lower than in EU and meeting this deficit requires about 12-15 years. On the other hand, the price of flats is pushed up by limitations on the supply side caused by administrative hurdles: lack of spatial development plans, lack of protected terrain and protracted administrative procedures requiring over one year of administrative efforts to begin investment. Barriers limiting supply on the property market are also created by the lack of an immigration policy that would allow the inflow of workers into Poland during a period of high economic emigration of Poles.

As a result, prices of Polish property are dependant on changes in demand for cheap and easily accessible mortgages, as well as barriers on the supply side, mainly of an administrative nature.

This is good breeding ground for speculative bubbles. Recently also foreign speculative demand has begun to play a more important role.

In these conditions curbing demand by increasing interest rates should be treated as the last resort, only if prior preventive and prudent measures or changes in economic policy aimed at unclogging supply on the market have proved impossible or ineffective.

Supervisory measures could be limited to banning mortgages without a borrower's minimal input, for instance of 10% of the house's market value. At the same time, administrative barriers should be gradually, and by no means suddenly, unblocked. The initiatives of subsidising mortgages from public money should be discontinued, as they stimulate additional credit expansion of banks.

The most risky scenario would be an excessive accumulation of measures limiting price increase for property or any other overtly restrictive actions that could set off a crisis mechanism through a drop in prices. Maintaining the stability of the financial system in Poland and high growth requires, then, skilful coordination not only of monetary policy and prudent and supervisory measures, but also of the economic and social agendas.

For Poland, a very important lesson from the current crisis on the US market is the necessity of all credit market players initiating the credit process - borrowers, brokers, credit agents and

sellers - participating in credit risk costs. This stems directly from the conclusion recently drawn by US supervisors as a result of analysis of the current crisis¹.

For borrowers this would mean lack of any possibility of incurring credit without their own input. In the case of brokers and sellers, it would be connected with the necessity of remunerations based on the so-called "bonus banks." Bonus banks (a part of the deposited commission for a seller or a broker) creates security for the creditor for a certain period of time against the risk of taking sold credits too easily. Other countries' experience also show a big role in limiting risk of good practice codes, threatening credit intermediaries and banks with loss of reputation.

Regardless of the details of a specific solution, Polish credit market players are faced with the challenge of reducing crisis-breeding phenomena in the current credit expansion context. It is no big deal to halt credit expansion and cool the economy via higher interest rates, but this requires some skill in maintaining credit market development and avoiding crisis-breeding incidents.

¹ See: Gardineer G.N., *Residential Mortgage Lending: Lessons from the Current Crisis*, Presentation for Polish Bank Association, Warsaw, 6 November 2007.