

Box 1

**INSTITUTIONAL DIFFERENCES BETWEEN MORTGAGE MARKETS IN THE EURO AREA
AND THE UNITED STATES**

There are several institutional differences between mortgage markets in the euro area and the United States, including differences in mortgage characteristics and in mortgage financing structures. Such differences may contribute to explaining differences in household indebtedness and the importance of securitisation. Against this background, this box investigates the role of government-sponsored enterprises in mortgage funding in the United States and compares it with mortgage funding practices in the euro area. It also discusses differences in foreclosure procedures, which may have an impact on household borrowing behaviour.¹

The role of government support in mortgage financing in the United States compared with the euro area

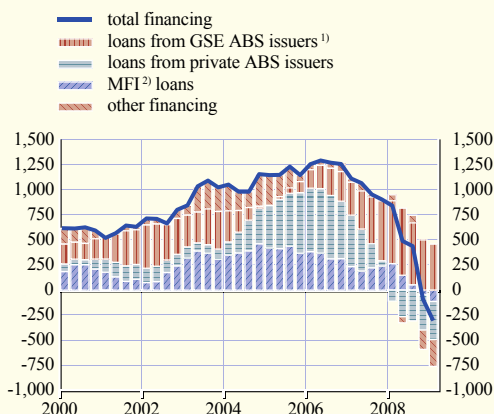
A specific feature of the US mortgage market is the key role played by government-sponsored enterprises (GSEs), which has its origin in the Great Depression, when a government agency called the Federal National Mortgage Association (FNMA) was founded. The latter was then privatised in 1968 and became known as Fannie Mae. In addition, a second private GSE operating in the US mortgage market – i.e. the Federal Home Loan Mortgage Corporation (or Freddie Mac) – was founded in 1968. Both GSEs acquired their current central role following the savings and loan crisis in the 1980s, which led to major structural changes in the US mortgage markets. Up to the late-1970s, savings and loan (S&L) institutions funded long-term fixed rate mortgage loans on the basis of mostly short-term deposits in an environment of stable interest rates. However, the rise in nominal interest rates due to inflation, in combination with ceilings on deposit rates, led to withdrawals of funds by customers who placed their savings in higher-remunerated assets (disintermediation). This development led to capital shortages at S&L institutions which were further aggravated in the 1980s as a consequence of risky investments that these institutions undertook following their deregulation. The removal of mortgage loans from the balance sheet of S&L institutions, by selling them to the two GSEs, enabled S&L institutions to grant mortgage loans despite lower deposit-to-loan ratios than in the past. In addition, after selling a fixed-rate mortgage loan (the type generally preferred by US homebuyers), the S&L institution does not bear the risk of rising interest rates.

As a consequence of such historical developments, fixed rate mortgages in the United States are typically sold by mortgage banks to the GSEs, provided that they meet certain quality standards, or to private issuers of asset-backed securities (ABSs), which either hold them on their balance sheet or securitise them. In recent decades, the two GSEs enjoyed lower funding costs compared with private banks when issuing mortgage-backed securities (MBSs) owing to an implicit government guarantee. This guarantee was turned into an explicit guarantee in September 2008 given that Fannie Mae and Freddie Mac were put under conservatorship. Under this arrangement, GSEs and ultimately the US government support the provision of mortgage credit in the United States. Moreover, by pooling mortgages and issuing relatively standardised mortgage-backed securities,

¹ The evidence presented in this box relies mainly on R. K. Green and S. M. Wachter, “The American Mortgage in Historical and International Context”, *Journal of Economic Perspectives*, Vol. 19, No. 4, Fall 2005, pages 93-114; A. Coles and J. Hardt, “Mortgage markets: why US and EU markets are so different”, International Union for Housing Finance, December 2001; and European Central Bank, “Housing finance in the euro area”, Occasional Paper Series No. 101, March 2009.

Chart A Financing of US households

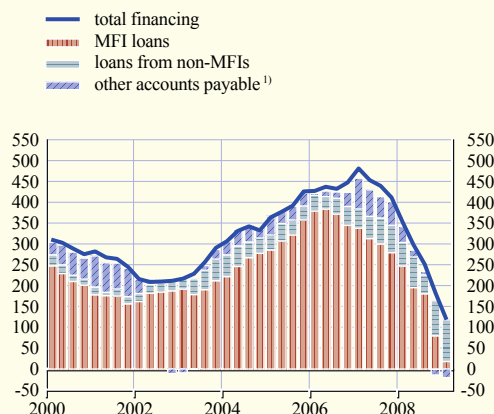
(four-quarter cumulated transactions in USD billions)



Sources: Board of Governors of the Federal Reserve System and ECB calculations.
 1) Loans from GSEs and from agency and GSE-backed mortgage pools.
 2) Commercial banks, savings institutions and credit unions.

Chart B Financing of euro area households

(four-quarter cumulated transactions in EUR billions)



Source: ECB.
 1) Also includes trade credit and net liabilities of financial derivatives.

Fannie Mae and Freddie Mac promoted the liquidity in the US secondary mortgage market. In terms of amounts outstanding, the GSEs are the main holders of mortgage debt. At the same time, private ABS issuers, typically unregulated non-depository institutions, had considerably increased their market share from 2004 up to the financial turmoil, in parallel with the imposition of regulatory limits on the activity of GSEs (see Chart A).²

By contrast with the United States, in the euro area, there is no comparable government support for the provision of mortgage credit to euro area residents, i.e. euro area governments do not act to reduce banks' funding costs of mortgage loans or to favour the removal of loans from banks' balance sheets. This picture has been altered somewhat by the financial turmoil and the specific government support measures which have been introduced at the country level. In addition, there are considerable differences in accounting rules across euro area countries. Accounting rules in some euro area countries only allow a full removal of true-sale securitised loans from banks' balance sheets (i.e. a derecognition) when the securitisation transaction meets certain strict criteria.³ By contrast, accounting rules in the United States make it generally easier to derecognise loans from banks' balance sheets and, hence, to move associated risks to third parties. These reasons may explain to a large extent why the securitisation of mortgage loans by GSEs or private ABS issuers has been so much more advanced in the United States compared with the euro area.

In the euro area, mortgage loans remain to a large extent on banks' balance sheets (see Chart B). In addition to deposits, which are generally the most important funding source of euro area banks, housing loans are financed directly via the issuance of mortgage covered bonds and residential mortgage-backed securities (RMBSs), which are collateralised by mortgages (see Section 3 of the

² According to the consolidated banking statistics from the Bank for International Settlements, 6% of the total foreign claims of euro area banks were vis-à-vis the United States at the end of March 2009.

³ See Box 3 entitled "The importance of accounting standards for interpreting MFI loan statistics" in the March 2008 issue of the Monthly Bulletin.

article entitled “Housing finance in the euro area” in this issue of the Monthly Bulletin on the funding of mortgage loans in the euro area). The collateralisation of the bond issuance generally lowers banks’ funding costs. However, unlike the (implicit) government guarantee in the United States, there is no comparable government support in mortgage funding costs in the euro area. In the case of covered bond issuance, mortgage loans remain on banks’ balance sheets in the euro area, and in the case of RMBSs, mortgage loans are only partly removed from banks’ balance sheets, depending on the national accounting rules for derecognising true-sale securitised loans. Hence, also the default risk associated with mortgage loans remains to a large extent on banks’ balance sheets. Secured market-based funding of mortgage loans accounted for 21% (9% for mortgage covered bonds and 12% for RMBSs) of the amount outstanding of housing loans in the euro area at the end of 2007. In the United States, the share of securitised mortgage loans was approximately 50% of the amount of mortgages outstanding.⁴

Implications of the structure of mortgage funding for mortgage loan characteristics

The importance of mortgage securitisation in the United States, including the role of GSEs and private ABS issuers, led to the dominance of fixed rate mortgage loans, which are traditionally preferred by US homebuyers. An important reason for the willingness of banks to grant fixed rate mortgage loans is that banks did not need to bear the risk of financing long-term assets with short-term funds, as they could generally remove long-term mortgage loans from their balance sheet. By contrast, in the euro area, there is a large number of countries in which variable rate housing loans dominate and a minority of countries in which fixed rate mortgage loan contracts are dominant, related to demand, supply and institutional factors (see Section 2 of the article entitled “Housing finance in the euro area” in this issue of the Monthly Bulletin).

In addition, during recent years and up to the financial turmoil, new atypical contracts have been introduced in the United States with so-called “teaser rates”, negative amortisation rates and loan-to-value ratios of close to or above 100%, especially in the sub-prime segment. The higher default risk of such sub-prime mortgage loans was to a large extent removed from banks’ balance sheets, and was possibly mostly transferred to private ABS issuers which were less regulated than GSEs. Such atypical contracts were used to a lower extent in the euro area, probably related to accounting rules making it less easy to derecognise loans.

Furthermore, in the United States prepayment fees are generally minor or non-existent. By contrast, while partial or total early repayments are allowed in all euro area countries, fees are generally charged for the early repayment of fixed rate housing loans, whereas early repayment is free of charge in the case of variable rate housing loans in several euro area countries.

Insolvency and foreclosure procedures

With respect to further institutional differences between mortgage markets in the euro area and the United States, there are also some key differences between insolvency and foreclosure procedures in the euro area countries and the United States, which may contribute to explaining differences in household indebtedness. Due to the limited availability of data and owing to the heterogeneous situation among euro area countries, only a broad assessment based on predominantly qualitative information is possible.

⁴ Referring to off-balance-sheet true-sale securitisation.

While the number of personal bankruptcies has increased in the euro area and the United States during recent years, personal insolvencies are still less common in the euro area than in the United States. This is related to important differences in the legal framework between countries governed by common law (e.g. the United States) and countries where legislation is based on civil law, which is the case in most euro area countries. In the United States, the system in the majority of US states tends, in practice, to work as if loans are non-recourse debt, i.e. debt that is secured by collateral, but for which the borrower is not personally liable. By contrast, in countries with civil law, borrowers are less easily released from the obligation to repay their debt and remain personally liable for any difference between the value of the property and the amount of the loan. In addition, judiciary procedures tend to be rather long in some euro area countries, whereas countries governed by common law tend to prefer non-judiciary settlements. Such differences in insolvency and foreclosure procedures may have an impact on the lending conditions and thereafter the indebtedness of households. Moreover, in relation to the financial turmoil which had its origin in the US sub-prime market, the increase of personal insolvencies was much stronger in the United States than in the euro area (based on limited information on a few euro area countries) in 2007.

Conclusions

The specific features of the US mortgage market, with a dominant role for GSEs and private ABS issuers and a relatively low proportion of mortgage loans remaining on banks' balance sheets, are advantageous in terms of lower funding costs and the pooling of risks through the securitisation of mortgage loans. At the same time, banks' ability to remove mortgage loans relatively easily from their balance sheet has fuelled household mortgage indebtedness during recent years up to the start of the financial turmoil in mid-2007. In addition, structured transactions and the growth of relatively lightly regulated private ABS issuers up to the financial turmoil have led to an opaque distribution and underestimation of risks in the financial system. In the end, this triggered the outbreak of the financial turmoil.

By contrast, in the euro area, housing loans remain to a large extent on banks' balance sheets as they are mostly financed via bank deposits or, to some extent, via the issuance of covered bonds. Moreover, the importance of RMBS issuance in the euro area is relatively low. Generally, while accounting rules differ across euro area countries, loans can be less easily removed from banks' balance sheets than in the United States. The fact that loans remain to a large extent on the balance sheet of regulated institutions, i.e. banks, tends to support a more cautious behaviour of lenders with respect to the loans originated. At the same time, the heterogeneous legislation with respect to covered bond and RMBS issuance as well as non-standardised mortgage loans have resulted in lower securitisation of mortgage loans in the euro area. Generally, higher loan securitisation would enhance the liquidity of the secondary market and may reduce funding costs, which would be beneficial for borrowers. This notwithstanding, as the financial turmoil has shown, for the stability of the financial system, it is important to keep risks transparent and, to a significant extent, on the balance sheets of well-regulated institutions.