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# **Consumer Information & Protection in Mortgage Finance**

## **Some lessons from subprime and issues in emerging mortgage markets**

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# Overarching goals of consumer information & protection

- Enable consumer to **informed decision-making** on biggest lifetime financial decision and create **fair competition** between lenders
- **Reduce default risk** and **credit losses** by ‘materially’ protecting the consumer

→ Stabilize demand through greater consumer confidence

→ Reward fair lenders and improve market performance

→ Avoid future debt crises

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# All you can do wrong in a single crisis (Subprime) – material protection issues

- **Inflating house prices** beyond long-term trend
  - Inflationary monetary policy / foreign capital inflows;
  - Equity withdrawal / household leverage to pump-prime;
  - Short-term (open market) valuation.
- **Pushing people into inflated houses** by
  - Piggyback, 100% lending;
  - Lowering initial payment w. future payment shock risk (hybrid, option products);
  - Excluding leverage / LTV as factors from scoring (PD models).
- **Distorting intermediary incentives**
  - Low-/no-documentation loan abuses (information available);
  - Haircut system for packagers / originators without first loss retained;
  - 3% broker origination fee in subprime vs. 1% in prime;
  - Fraudulent appraisal as fees depend on volume, not risk.
- **Render NPL servicing unmanageable or costly**
  - MBS multi-investor system with complex decision-making rules;
  - Disincentives for servicers subjected to flat fees;
  - Tax disincentives for restructuring (capital losses non-deductible).

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# All you can do wrong in a single crisis (Subprime) – consumer information, policy issues, lessons

- **Intransparency**, partly on purpose
    - Product complexity to reduce consumer visibility, risk transparency;
    - “Consumer” (low teaser rates) vs. “investor” APR (fully indexed fully amortizing);
    - Lack of independent advisory, non-distorted information provision.
  - Ill-designed **policy framework**
    - Public guarantee focus changed from low- to middle- (now high-) income;
    - Tax deduction for piggybacks, but not for insurance;
    - No downpayment support program, rental policy stigmatized;
    - Distorted regulation & supervision structure.
  - **US lessons for emerging markets**
    - Overreliance on transparency regulations while problems were material;
    - Risk layering: fraud/operational, payment shock, negative equity risks;
    - Housing, monetary policy environment part of cons protection framework;
    - Weak public regulation capacity = weak support for min standards;
- Consumer protection = investor protection!**

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# Typical material consumer protection issues in emerging markets

- Usurious or simply unaffordable **interest rate levels**;
- Fast growing system with **house price inflation**, creating **risky products missold as access products**, fast;
- **Mandatory cross-selling** of unnecessary or costly products;
- Interest rate **adjustment** risky or costly for consumer;
- Loans **do not amortize** within the contractual maturity;
- Outstandings may balloon for other reasons, e.g. forex indexation;
- **Unfair contract terms**,
  - e.g. retaining principal (against lower rates), requirements to purchase additional services from lender (e.g. insurance) or limitation of ownership rights
- Unfair treatment during **default & foreclosure**, self-defeating foreclosure practices (further driving down prices);
- Due to absence of construction financing, high **exposure of consumers to construction / project finance risks**;
- Most importantly: **lenders often do not assess household affordability and shock absorption capacity properly.**

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# Legislation Focused on Material Protection & Capacity Building - South Africa 2006

## ■ **National Credit Act:**

- Lender must assess affordability ex-ante, failure may lead to inability to secure a debt judgment;
- Full quotation of the costs, the final sum you must repay, the installments and the interest rate;
- Usury: interest rates for mortgage products are capped at the 2.2 times the Reserve Bank Repurchase Rate (9.5% in July 2007) plus 5% per year; origination fees are limited to a maximum of R5 000 and monthly fees to a maximum of R50;
- No forced insurer designation by lender;
- De-facto no grandfathering - ex. credit affected if conditions materially change.

## ■ **National Credit Regulator**

- Processes consumer complaints and interacts with lenders;
- Forwards to National Consumer Tribunal in case of lender non-compliance;

## ■ **Credit Information Ombudsman** – last resort for credit registry entry disputes.

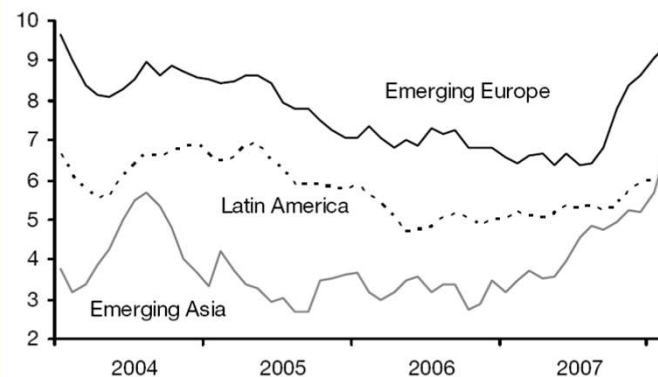
## ■ **Impact assessment**, preliminary:

- Positive: limited high-LTV lending, slower credit growth, house price decline;
- Negative: some credit crunch effects; no payment shock protection rules, leave consumers exposed (ARM loans).

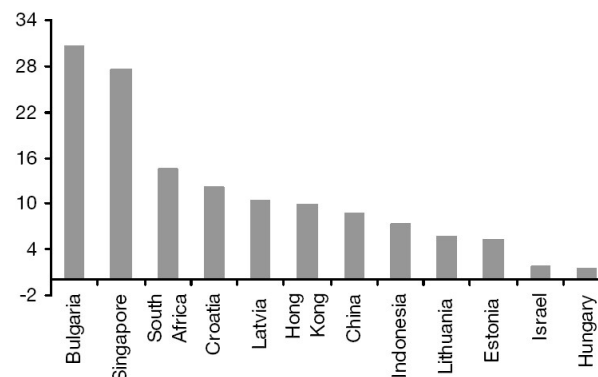
# Payment shock risk – relevant again

- Most EMs now again exceeding 10% mortgage rates due to **reinflation**
- Most EMs using some form of adjustable rate loan instrument:
  - Loans **capitalizing the inflation component (PLAM)** → high debt service risk when real incomes fall;
  - **Dual-indexed** mortgage (wages, inflation) keep debt service ratio constant, but may leave residual debt;
  - **Forex loans** look cheap (rates), but carry great payment shock risk;
  - **Riding the yield curve** by shifting from FRM to ARM with similar effects.
- Strong house price increases provide **disincentives to save** & increase leverage → often excessive product innovation pace.

Change in Consumer Prices  
percent on a year ago basis

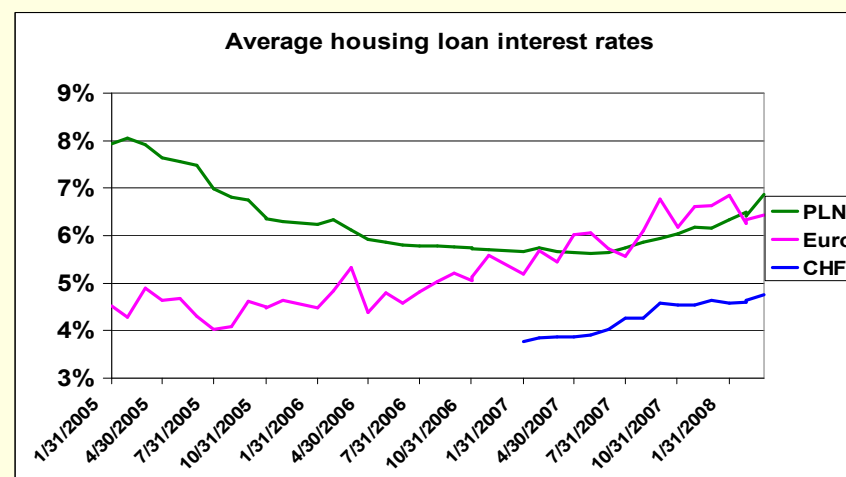
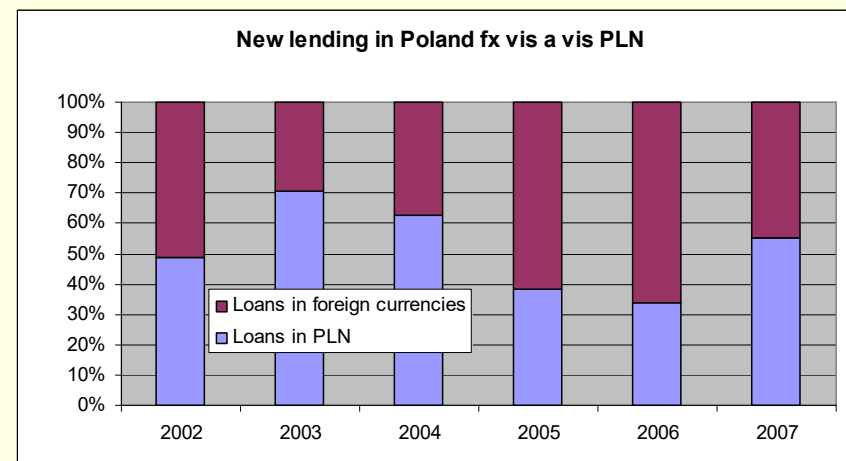


House Price Inflation  
percent on year ago basis, 2007Q3



# Legislation focused on Payment Shock Protection – Poland 2006

- **‘Recommendation S’**
  - APR and other **transparency rules**;
  - **Underwriting** based on (interest, outstanding) **stress test**:
    - PLN-Forex change of **+/-20%**;
    - Forex interest = PLN interest;
  - Consumer has to **explicitly refuse local currency loan**.
- **Impact assessment**, preliminary:
  - Forex share declines;
  - Main driver seems to be interest rate convergence;
  - No explicit requirements for caps.
- **Mandatory forex/ARM payment risk caps alternative** (Turkey).

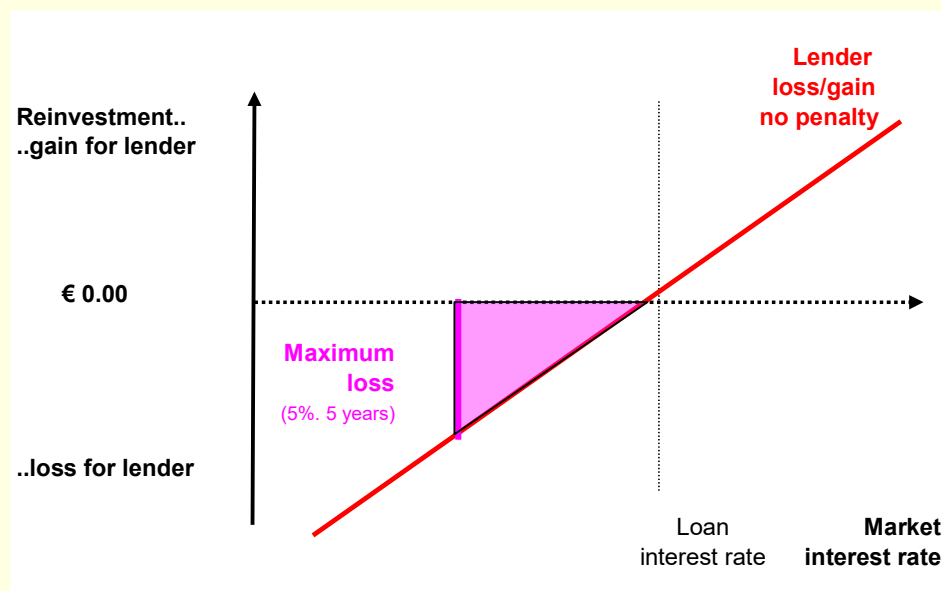


Source: National Bank of Poland.



# Fixed-rate lending and prepayment penalties

## Prepayment penalties – fair value w. ceilings



Source: Finpolconsult.

E.g. max 5 % of loan volume or 5 years residual fixed-rate term

- Without PP many fixed-rate **funding models** are **unsustainable**;
- “**System switch**” from **FRM** to **ARM** **serious risk** (Italy, Spain, India);
- **Yield maintenance** ideal solution (fair value, flat fee always wrong);
- **Problem**: if interest rates are high (risky loan, macro issues) and remaining fixed-rate terms are high, yield maintenance may lead to higher defaults;
- Solution can be ‘**fair value with ceilings**’, legislation with flexibility to change limits as risk situation changes; allows e.g. for 2-5 yr straight (quasi government) bond issues;
- Does not solve symmetry issue → delivery option (Denmark).

# Consumers financing the development phase

## Private developer project escrow account process practiced in Turkey



Source: Finansbank. Note: Turkey with legal linked contract assumption.

- Transparency
  - **disclosure of economic ties** bank & developer (e.g. joint marketing, 1-1 relations).
- Material protection
  - **technical separation of consumer and developer capital** (cash escrows / project SPVs);
  - **lender liability for consumer-developer contract (linked contract assumption)**;
  - **mandatory third-party completion guaranty**;
  - **legal limitations** on consumer equity or debt finance involvement.

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# Responses to material consumer protection issues

## - summary

- To fight **usury**, publish interest rate conditions on public agency or regulator websites; use relative rather than absolute rate ceilings;
- Require **official interest rates** (interbank, government bond) **as benchmarks** for adjustable-rate loans, with **fixed spreads**, at least to term;
- Require short-term **caps** for adjustable-rate loans, including forex (first years of loan life suffices);
- Increase **transparency requirements** for **adjustable-rate loans**, e.g stress tests;
- Require provision of planned **amortization schedules** to consumers for all loans;
- Impose **constraints** on certain types of **non-amortizing loans** (e.g. quotation of ceilings for negative amortization), at least increased transparency;
- Develop **fair-value based prepayment penalty** concept with ceilings;
- Ban **unfair contract terms**;
- Impose some form of lender liability if banks lend to consumers financing **economically tied developers**.

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# Risks, costs and benefits associated with material consumer protection rules

## ■ Risks:

- Usury rules may push borrowers into **informal credit market** (moneylenders);
- Rules limiting ballooning or foreign-exchange credit may trade against **affordability**, esp. in presence of inflation;
- Limiting product choice may lead to **lower innovation** and **higher credit costs**;
- **Reduced foreclosure** penalties may lead to higher credit costs for all consumers;
- **Eliminating prepayment penalties** may remove fixed-rate products.

## ■ Costs:

- Inexperienced lenders might make **losses**, e.g. due to mismatch or credit losses;
- **Responsible lending** rules with potentially large liability costs.

## ■ Benefits:

- Addresses risks that cannot be dealt with by information only, e.g. due to **risk amnesia of consumers**;
  - Lowers default risk by selecting **high-safety products and covenants**.
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# Typical consumer information problems in emerging markets

- Intransparent and unfair **advertisement**;
- Limited **exchange of information** at the pre-contractual and contract closure stages;
- **Hidden costs** raising the costs of credit (incomplete information);
- **Hard-to-compare** cost information;
- **Selective information provision to consumers** for whom most profitable products for lender may not be suitable;
- **Excessive personal information** requested, abuses of information;
- No **mediation capacity** available in case of conflicts.

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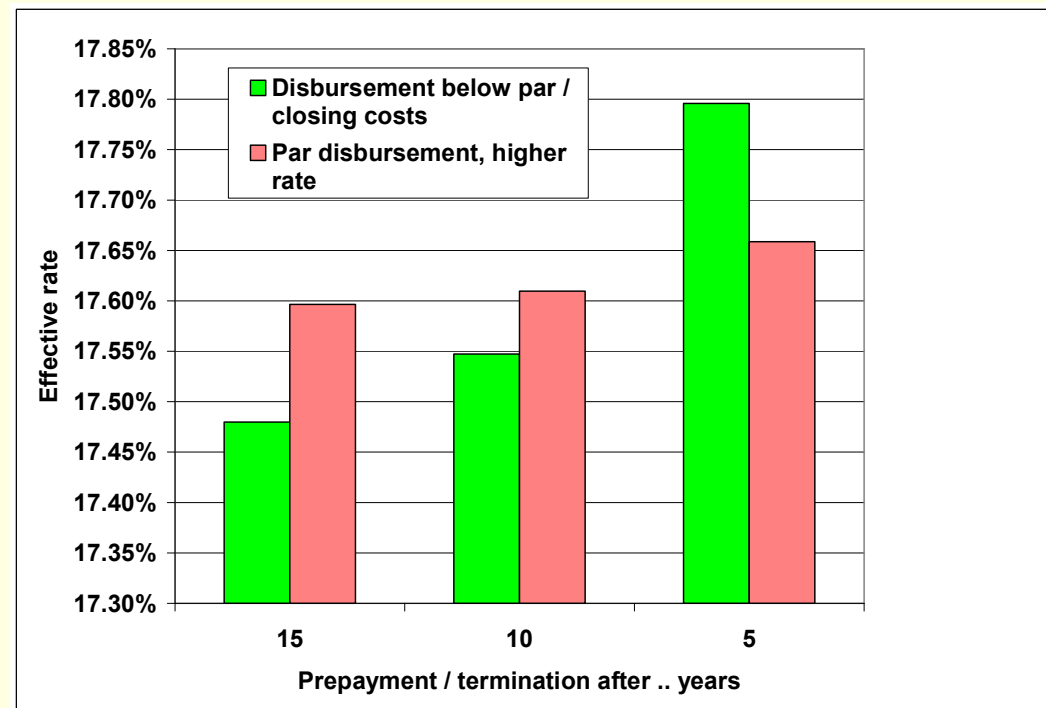
# Legislation focused on Transparency and Capacity Building – Mexico 2002

- **Federal Law on Transparency and Promotion of Competition in the Guaranteed Credit Market** mandates, inter alia:
  - a total cost of credit concept (effective interest rate),
  - a disclosure standard for contract terms,
  - a binding loan offer period of 20 days,
  - appraisal standards and authorization of appraisers as well as
  - minimum contents of contracts.
- **Capacity:**
  - The Federal housing finance agency, **SHF**, is mandated to provide monthly comparative loan offer information to consumers.
- **Impact assessment**, preliminary:
  - Positive: Greater efficiency of borrower-lender relations needed in a market plagued historically by frequent court and political interventions
  - Negative: SHF seen by lenders as competitors → loan offer data problems; loan offer period too long → pipeline risk

# Effective rate calculation comes with problems: e.g. prepayments shorten loan durations

- Duration / **prepayment assumptions** crucial for APR calculation;
- In ARM lending assumption of constancy of interest rate;
- Solution: **classify mortgage products** by duration classes, then compare APR;
- Long-term goal: **joint price and risk classification standard.**

Typical APR structures in Ukraine, 2 main types of UAH fixed-rate loans



Source: Finpolconsult, EU-TACIS project.

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# Responses to consumer information problems - summary

- **Standardised information sheet** covering all relevant costs for advertisement;
- Nominal & **effective interest rate** (APRC), indication of transactions costs;
- **Full information** to be provided by bank about at least own products;
- **Objective credit assessment**, to limit default likelihood;
- Separate **loan offer**, clarifying individual loan conditions;
- **Written form** and **minimum content** of contract, copies for consumer;
- **Withdrawal** or cooling off **period**;
- Minimum **data protection** standards;
- **Independent counseling** to consumers;
- Independent **arbitration & mediation**.



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# Risks, costs and benefits associated with consumer information rules

- Risks:
  - **excessive consumer information**, e.g. U.S.: typically 5-6 prices (incl. title insurance, loan insurance, fees, points..); better only two quotes – e.g. total costs of credit and borrowing costs;
  - **misleading consumer information**, example APRC above;
  - Conflict of interest – if a lender is required to counsel → independent counseling;
  - Pipeline (loan offer period) & warehousing (withdrawal period) risk.
- Costs:
  - **Bureaucracy costs** may be significant, if too comprehensive information is required. Example: U.K. M-day.
- Benefits:
  - Better information **reduces default risk** creating positive direct benefits for both consumer AND lender, possibly also government (less need for subsidies);
  - mandatory information **reduces unfair competition**, e.g. lenders advertising with low nominal but high effective rates;
  - With a clear legal framework present, a lower frequency of adverse reactions of the **judiciary system** may be expected.

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## **FOR ALL CONSUMER PROTECTION LEGISLATION/REGULATION**

### **HANDLE WITH CARE !!**

- 1<sup>st</sup>: empirical review of the problem
- 2<sup>nd</sup> interaction with industry & consumers
- 3<sup>rd</sup> regulatory action

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# END

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