Factors affecting financial institutions

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Abstract

For the first time in world history, more people now live in cities than in rural areas. As a consequence, the successful development of efficient and stable mortgagefinancesystems is now of global importance because economic productivity as well as the quality of life in cities depend on efficient financial services for sound urban investments.

At present, housing finance systems remain underdeveloped in most developing countries where residential mortgage lending is typically small in scale, difficult of access and only bank-based with little reliance on capital markets. Yet, comparative work on housing finance systems has barely begun. In particular, there is no systematic work on the great diversity of experiences across the 184 countries that are currently members of the International Monetary Fund and the World Bank.

Based, on the latest comparative data available, this paper presents an initial overview of the scale and depth of overall financial systems in 180 countries and shows why three tiers of financial systems should be distinguished in evaluating performance and selecting policies. Then the paper examines five recurring structural constraints that often affect the scale and depth of mortgage finance systems in developing economies and differentiate them from mature financial systems. To clarify the overall financial contexts in which mortgage finance systems must expand, the paper reports findings from the first global survey of financial systems carried out in 1999 at the World Bank. This survey reveals regularities in the way the structure of financial systems evolves across income levels, which are important in shaping options to develop a given mortgage finance

system. Within the three tiers of financial systems previously defined, on-going research shows that five broad types of financial systems shape the specific options available to develop mortgage finance systems market.

Introduction

At present, the economy of Turkey has been expanding strongly, registering growth rates of 8. 9% and 7. 4% for the 2004 and 2005 fiscal years respectively[1]. This is a much greater improvement from the early 1970s when the Turkish Economy reached its worst crisis since the fall of the Ottoman Empire. During this period, the Turkish authorities had failed to take sufficient measures to adjust to the effects of the sharp increase in world oil prices in 1973-74 and had financed the resulting deficits with short-term loans from foreign lenders. By 1979 inflation had reached triple-digit levels, unemployment had risen to about 15 percent, industry was using only half its capacity, and the government was unable to pay even the interest on foreign loans.

The country's progress in recent years, however, has been remarkable. The benefits of the government's commitment to its economic program are clearly visible. Much has been achieved since the current reform program was started. The challenge that remains for Turkey now is to build on those achievements and exploit Turkey's potential as a rapidly-growing and increasingly sophisticated economy[2].

This study will examine the effect of these factors on the financial institutions of Turkey, especially the banks. The initial step of this study will provide a brief background on the historical antecedents that previously existed in Turkey to arrive at a better understanding of the fundamentals of

the Turkish financial institutions. The next step will be an examination of the legal framework of the study which is aimed at setting the parameters of what the financial institutions can do. This will be followed by a discussion on the other pertinent laws, rules and guidelines that govern the financial institutions of Turkey.

Relevance of Study

According to Anne O. Krueger, First Deputy Managing Director of the International Monetary Fund (IMF), the key to the resurgence of the Turkish economy lies in " raising the potential growth rate of the economy. Structural reforms-reforms that make the economy more flexible, that permit individuals and firms to respond to incentives more rapidly and more flexibly-will raise the economy's growth potential. More rapid growth, sustained over a long period, will raise living standards and reducepoverty."[3]

The study of the Turkish Financial Sector, therefore, is quite important because of the role that it plays in its resurgence. Turkey is amongst the leading developing nations but its economy has been eclipsed by chronic macroeconomic instability, heavy taxation and a weak loan portfolio superimposed by heavy government involvement.

Despite enormous obstacles, the Turkish Financial Sector has been able to sail through severe crisis and presently it is closer to achieving macro-stability than it has ever been in recent years. The Turkish Financial Sector presents a role model for rest of the developing world in setting up best practices and offers a tremendous opportunity for students of economics to

get a fair idea of the resilient nature of the financial sector during its evolutionary and revolutionary processes.

A study of the role that the banking sector plays in the Turkish economy will also help at arriving at a better understanding of how structural reform, which is a never-ending process in the modern global economy, can properly be achieved and sustained through a solid financial sector.

Historical Background

The new liberal economic policy in 1980’s aimed at integration with world markets by establishing a free market economy. As a reflection of this policy, this period witnessed continuous legal, structural and institutional changes and developments in the Turkish banking sector. In these years, a series of reforms were undertaken to promote financial market development. The main aim of these reforms was to increase the efficiency of the financial system by fostering competition among banks.

In this context, interest and foreign exchange rates were liberalized, new entrants to the banking system were permitted and foreign banks were encouraged to operate in Turkey. Turkish banks intensified their business relations abroad either by purchasing banks in foreign countries or by opening branches and representative offices. The liberalization of foreign exchange regulations increased foreign exchange transactions of the banks. Beginning in1984the special finance institutions, which are renamed as participation banks with recent changes in the banking regulations and operating according to Islamic banking principles, also became part of the financial system.

The InterbankMoneyMarket, which is administrated by the Central Bank, was established in 1986 with the purpose of regulating liquidity in the banking system. A uniform accounting plan and accounting principles as well as a standard reporting system were adopted in the same year. In 1987, external auditing of the banks in accordance with internationally accepted accounting principles was initiated. In addition, legal and institutional arrangements were introduced to foster the development of the capital market. As a result, banks began to provide additional services such as trading in securities, underwriting fund management, establishing mutual funds and financial consultation.

Besides diversifying their services, banks improved their technological infrastructure by extensive use of computer systems; began employing more qualified human resources; and at the same time put an emphasis on training programs.

Legal Framework and Supervision of the Banking System

All banks in Turkey are subject to the Banking Act and to the provisions of other laws pertaining to banks. Prior to the changes in the Banks Act No. 4389, which was issued on June 23rd, 1999, the Undersecretariat of Treasury and the Central Bank had been the two main regulatory and supervisory bodies in the banking sector. With this Act, the Banking Regulation and Supervision Agency (BRSA) with financial and administrative autonomy, was formed. The mission of the Agency is to safeguard the rights and benefits of depositors and create the properenvironmentin which, banks and financial institutions can operate with market discipline, in a healthy, efficient and

globally competitive manner, thus contributing to the achievement of long-run economic growth and stability of the country.

With the establishment of the BRSA, the Savings Deposits Insurance Fund (SDIF), which was under the authority of the Central Bank before, started to operate under the administration of the BRSA. Later on, with the enactment of the Act Nr. 5020 on December 26, 2003, the management of the SDIF was separated from the management of the BRSA. The decision-making body of the Agency is the Banking Regulation and Supervision Board (BRSB), which is appointed by the Council of Ministers and consists of seven members. Following the appointment of the members of the Board, the Agency commenced its operations as of August 31, 2000. Banks in Turkey have the status of joint-stock companies and are subject to general controls under the provisions of the Turkish Commercial Code and of various tax laws. Besides, banks are subject to special supervision by the Banking Regulation and Supervision Agency. As the representative body of the banking sector, the Banks Association of Turkey (BAT) aims protecting and promoting the professional interests of its members.

The BRSA exercises its supervisory authority on a direct and ongoing basis in terms of legal considerations and financial soundness. Additionally, the banks' financial statements are audited by external auditors in accordance with internationally accepted principles of accounting. Banks are also examined by their own auditors, who are required to submit quarterly reports to the BRSA. Recently, the supervisory system has been further strengthened by legislative arrangements and a number of decisions taken in accordance with the standards of the prudential regulation exercised by

the international banking community and in general covered the following banking related areas: foreign exchange exposures, capital adequacy, internal control and risk management, lending limits, conditions to be met by bank owners, bank ownership control in transfer of shares, consolidated and cross-border supervision of banks, accounting standards for financial disclosure purposes, prudential reporting and loan loss provisioning.

For the purpose of bringing further competitive force in the financial system, to minimize the risks that may arise, to decrease the costs of operation and intermediation to achieve integration with other regulations and implementations of financial markets, a more active and more transparent financial system by providing a more active course of the markets, new Banking Act (5411) was issued on November 1st, 2005. In the process of preparing this Act international standards including National Program, Urgent Action Plan of the 59th Government, European Union Improvement Report, Turkey Report of OECD, European Union Directives, BIS’s Core Principles for Effective Bank Supervision, Corporate Management Principles of OECD, the Laws of European Union Member Countries, important provisions which take place in the laws of certain countries, experiences and culmination of BRSA and SDIF were used.

One of the main highlights is that under this new regulation, the financial holding companies, leasing, factoring and consumer finance companies come under the supervision and surveillance of the BRSA. The act also provides new innovations such as the inclusion of the definitions of assurance fund, development and investment bank, Fund bank, participation bank, financial institution, financial holding company, control, qualified

share, savings deposit, private current account, participation account, participation fund, savings account, support service institution and off-shore banking which are now included in the Act.

The impact of this act is such that the activities that the banks may engage in are listed clearly and as compatible with the directives of the EU, in order to identify the financial institutions and determine the scope of effective supervision and surveillance. There are also provisions with regard to the conditions for a transparent and clear partnership structure, organization scheme which should not hinder the effective supervision of the BRSA, and principles of corporate governance are brought for the banks to be established in Turkey and a minimum YTL of 30 million paid-up capital is foreseen.

In attempt to further strengthen the confidence in the Turkish banking sector, within the principle of transparency, the banks shall now publish their articles of incorporation in their web-sites. Furthermore, for the banks and the financial holding companies, good governance is stipulated to govern by developing the principles of corporate management.

Perhaps one of the most significant changes instituted by thus act is the inclusion of provisions regarding the establishment of an audit committee with all members chosen from the non-executive members of the board of directors, to assist board of directors for on-side and off-side supervision activities. The main duties of the committee are determined as monitoring and assessing the adequacy of internal control, risk management and internal audit systems, ensuring accounting and reporting systems are operating in a sound manner and producing reliable information. It is stated

in the Act that the duties, authorities and responsibilities of the audit committee shall be determined by the board of directors.

Other changes that were included in this act call for the amendment of the principles concerning the authorization of auxiliary services institutions, the change in the minimum level of the capital adequacy is determined as 8% in parallel with other countries, and liquidity adequacy is foreseen in the Act. The Act also forbids banks to transfer funds to close the deficit of their funds and foundations established by their employees forhealthand social services, retirement saving purposes. It is adopted that the amount of donation which banks and institutions, subjected to consolidated supervision shall not exceed 4 per thousand of the bank's own funds and at least half of these donations can be done in fields exempted from tax by law. It is forbidden to carry on transactions with shareholders with dominant influence, board of directors, their husbands, wives and children and the subsidiaries causing hidden profit in better circumstance. Processes regarding to take corrective, rehabilitating and restrictive measures are listed in line with their priority. The institutions, the financial structures of which cannot be improved despite taking these measures, shall be transferred to the Fund or their license shall be revoked. The Act also includes provisions providing the Agency to work in a more effective, productive, transparent and accountable manner.

The independent auditing, evaluation and auxiliary institutions are now also compelled to get liability insurance for any loss stemming from their services. A supervision system which can respond to rapid changes and new necessities of the financial markets shall also be established. The institutions in the scope of the Act shall be audited by the professional staff of the

Authority or by independent audit institutions having specialist in these subjects, as well as sworn bank auditors.

All of these new provisions are designed at revitalizing the Turkish banking sector which is still recovering from the effects of the 1990 economic crisis which rocked the Turkish economy.

The Structure and the Financial Data

In a study entitled, “ Credit growth in Turkey: Drivers and challenges” by Erdem Ba? ç?[4] a discussion was made on the main drivers of the recent credit boom in Turkey and the potential problems and challenges associated with it. According to the paper, the basic problem in Turkey during the last fifteen years has been the relatively large stock of public debt compared with the small deposit base in the banking system. The recovery period, however, has witnessed a decline in the inflation rate single-digit levels for the first time in three decades and it is concluded by the author that the two main drivers of the recent credit boom observed in Turkey have been fiscal consolidation and disinflation.[5] This basically means that for the banking sector in Turkey to play a major role in the resurgence of the economy the deposit base needs to be strengthened to generate funds to be used for funding to allow banks to lend more to new industries to jump start the local economies.

Similarly, in another study, by Kibritcioglu entitled “ Banking Sector Crises and Related New Regulations in Turkey,”[6] a chronological account of the development of the banking sector in Turkey was done. It starts with a report on the past three decades of instability and crises in Turkish economy which were marked with populist macroeconomic policies, moral hazard problems,

huge public sector deficits, high real interest rates, overvalued Turkish lira, strong currency substitution, large current account deficits, volatile short-term international capital flows, extremely risk-taking behavior of banks, volatile economic growth, and high and persistent inflation resulted in several successive crises in the real and financial sectors. It then recounts how Turkish economy was able to recover from its banking and currency crises in the year 2001 thru a restructuring and rehabilitation of the banking sector.

The future of the Turkish banking sector is then presented in the end: increasing macroeconomic stability, improving sovereign creditworthiness, higher economic growth, increasing domestic savings and EU-related institutional reforms during the EU-convergence process within the coming 10 to 15 years, and increased consolidation and foreign competition. This study further supports the theory that the key to the resurgence of the banking sector lies in its being able to encourage more savings in the domestic market which will also lend to the improvement of creditworthiness of not only the local businesses but of these financial institutions as well.

In understanding the relevance of improving the credit worthiness of banks and local businesses in Turkey, it is important to first analyze which industries contribute to the financial and economic growth to the Turkish economy. In the years after World War II, the Turkish economy became capable of supplying a much broader range of goods and services. By 1994 the industrial sector accounted for just under 40 percent of GDP, having surpassed agriculture (including forestry and fishing), which contributed about 16 percent of production. The rapid shift in industry's relative

importance resulted from government policies in effect since the 1930s favoring industrialization (see fig. 8). In the early 1990s, the government aimed at continued increases in industry's share of the economy, especially by means of export promotion.

Services increased from a small fraction of the economy in the 1920s to just under half of GDP by 1994. Several factors accounted for the growth of the services sector. Government--already sizable under the Ottomans--expanded as defense expenditures rose; health, education, and welfare programs were implemented; and the government work force was increased to staff the numerous new public organizations. Trade, tourism, transportation, and financial services also became more important as the economy developed and diversified. These developments however relied heavily on banks for financing which led to interest rate hikes and increases in the non-performing loans of local banks. Increasing the loanable funds of banks through improvements in domestic savings and creditworthiness will therefore give these important industries the capital boost that is needed to generate economic growth.

There are 47 banks operating in Turkey as of January 2006. 13 of these banks are investment and development banks, and the rest are commercial banks. Three of the commercial banks (excluding 1 SDIF bridge bank) and three of the investment banks are state owned. Total number of the foreign banks is 13. There are 4 participation banks also. There are no local banks, and most of the banks are multi-branched. The total number of branches in the system declined to 6, 568 as of December 2005 after the crises and the restructuring program. There were mergers and liquidations of the SDIF

banks and also closures of branches during the restructuring of state owned banks.

One third of the assets of the Turkish banking system are controlled by the state-owned banks. The number of these banks is three; their total share in the financial system as of December 2005 is 30. 6%. While they have collected 37. 6% of the total deposits by December 2005, they have extended 20. 2% of the total loans. Private commercial banks' share in the total assets of the sector was 53. 9 % as of December 2003. They have extended 65. 4% of the total loans of the sector while they have collected 55. 1% of the total deposits. Total amount of the deposits of the sector by the end of December 2005 is TL 243. 1 quadrillion (USD 181. 1 billion). 63. 6% of these deposits is denominated in TL and rest 36. 4% percent in FX. The three state-owned banks hold 37. 6% of, while 5 large scaled private banks hold 46. 2% of the total deposits. The fact that 89. 7% of the total is held by the 10 large scale deposit banks shows the high level of concentration in the sector. The maturities of most of the deposits are short-term. Deposits having maturities of less than three months constitute about 89. 9% of total deposits.

Since 2002 total assets of Turkish Banking System is growing steadily. As of 2005 total assets reached USD 295. 8 billion. During this period loan portfolio TBS also displayed an impressive growth. As of December 2005, the amount of in-cash loans extended by banks was USD 111. 7 billion and the ratio of loans to deposits was 64. 5%. The non-performing loans which amounted USD 9. 6 billion in end-2001, decreased to USD 5. 6 billion as of December 2005. The amount of provisions set aside for these loans was USD 5. 0

billion. Securities portfolios have an important part in the balance sheets of banks. Total placements made on public securities by banks were TL 143. 0 quadrillion (106. 5 billion USD) as of December 2005 leading to the conclusion that TL 59 of each TL 100 deposits collected was lent to the Treasury.

The results of the financial and operational restructuring of banking system show that there is an improvement in the profitability ratios of the whole sector. The net profit of state-owned banks and private banks which amounted TL 0. 9 quadrillion and TL1. 4 quadrillion respectively as of November 2002, increased to TL 1. 4 quadrillion and TL 2. 8 quadrillion in December 2003. Capital structures of the banks in the system were the core of the restructuring program. The three-phase audit revealed the real capital needs of private banks. The capital structures of the banks having capital shortage were strengthened and capital was set aside for market risks. Average capital adequacy ratio of the whole sector as of December 2005 is 24. 2%. The open FX position of the system, which was a continuous problem of the last decade, decreased to USD 157 million by December 2005 from a level of USD 14. 6 billion in December 2000. In addition to the foreign exchange risk, the interest rate and credit risks came down to manageable levels.

In parallel with the improvements provided by the Banking Sector Restructuring Program, several policies concerning the high intermediation costs which have a negative effect on the competitive structure and effectiveness of sector were implemented. The Government and related institutions are making considerable efforts in order to decrease the

intermediation costs caused by the taxes and other public liabilities. In this context, recently stamp duty and charges on loans were removed, deposit insurance premiums were considerably decreased, and special transaction tax on deposits was eliminated.

Banking Sector Restructuring Program

Following the November 2000 and February 2001 crises, which had negative impacts both on the economy and the banking system, an extensive streamlining plan, Banking Sector Restructuring Program was started and announced to the public in May 2001 by the BRSA. The restructuring program was based on the following main pillars: (1) Restructuring of state banks, (2) Prompt resolution of the SDIF banks, (3) Strengthening of private banks, and (4) Strengthening the regulatory and supervisory framework. Progress achieved in these fields is presented below.

Restructuring of State Banks

Financial restructuring of state banks was completed, and correspondingly they began to make profits. Similarly, significant steps have been taken within the framework of operational restructuring. Organizational, technological, product, human resources, loan issue, fiscal control, planning, risk management and service structures of the banks have been restructured in compliance with requirements of modern banking and international competition. Besides, number of branches of the state banks which was 2, 494 as of December 2000 was brought down to 2, 110 as of December 2005; and number of personnel which was 61, 601 was brought down to 38, 037.

A resolution plan was put into force with regard to the restructuring program of Ziraat and Halk Bank (Emlakbank was transferred to Ziraat in July 2001).

The resolution strategy for the duty loss problem (losses incurred by the state banks due to subsidized lending) included two components: Preventing new duty losses (aside from interest accruing on past duty loss claims) and managing the stock of outstanding claims. The overall total resources transferred to the state banks with the aim of tying the duty loss receivables from Treasury (which reached TL 17. 4 quadrillion as of end 2000) to securities and providing capital support amounted TL 28. 7 quadrillion by the end of 2001. In addition to the removal of the duty loss problem and capital strengthening, the short-term liabilities of the state banks were eliminated and deposit rates of these banks are determined in line with the market rates.

Resolution of the SDIF Banks

20 banks were taken over by the SDIF between 1997-2003 while two banks (? mar and K? br? s Kredi) were liquidated directly without being taking over by the SDIF. After the BRSA started its operations on August 31, 2000 (in addition to the existing 8 banks) administration of 13 banks were assumed by the SDIF upon the resolutions of the BRSA. Of these 20 banks, 12 banks were merged; 5 banks were sold to domestic and foreign investors; and license of 2 banks was revoked. By the end of October 2005 there is only 1 bank (Bay? nd? rbank) left under the administration of the SDIF as a bridge bank which is not accepting any new business and is thus well along towards resolution.

With a view to accelerating resolution process, the SDIF banks have been subjected to a comprehensive financial and operational restructuring process. Accordingly, short-term liabilities of the SDIF Banks have been

liquidated and a portion of deposits and F/X liabilities has been transferred to the other banks. In addition, receivables under follow-up of the SDIF banks have been transferred to the Collection Department and thus efficiency in follow-up and collection activities is ensured. Likewise, subsidiaries and real estates of these banks are disposed by taking market conditions into account. As of December 2005, USD 2. 7 billion have been collected from receivables under follow-up.

Strengthening the Private Banking System

Strengthening private banks, whose financial structures and profitability performances were worsened due to the crises experienced, composes an important part of the Banking Sector Restructuring Program. Within the scope of the program focused on private banks, first steps were taken towards strengthening of the capital structures of private banks with their own resources and limiting the market risks. Along these lines, important progress has been realized in these areas. In the context of Bank Capital Strengthening Program, 25 private banks were subjected to a three-phased audit process. Cash capital increases, correction of provisions set aside for non–performing loans, positive changes engendered in the market risk and valuation of securities were taken into account during the evaluations and accordingly, three banks were determined to have capital needs. The capital needs of these banks were provided either by their shareholders and or by allocation of subordinated loan by the SDIF upon the resolution of the BRSA. By the end of December 2005 total own funds of the sector amounts TL 53. 7 quadrillion (USD 40, 0 billion). With the improvement observed in

profitability, the average capital adequacy ratio of the sector was realized as 24. 1 % as of December 2005.

Strengthening the Regulatory and Supervisory Framework

Concurrently with financial and operational restructuring of banking sector, significant progress has been achieved in legal and institutional regulations, which will strengthen the surveillance and supervisory framework, ensure competitiveness and efficiency and improve confidence in the sector.

In this context, regulations were issued to prevent risk concentration in loans, limit participation of banks in non-bank financial institutions and ensure preparation and disclosure of banks' balance sheets in compliance with international accounting standards. Among many other structural ones, banking reform intended to upgrade and modernize the current rules and in general covered the following banking related areas: capital adequacy, foreign exchange exposure, internal control and risk management, deposit guarantee schemes, accounting standards for financial disclosure purposes, prudential reporting and loan loss provisioning.

Results of the Restructuring Program

The implementation of the restructuring had the following effects on the Turkish Banking Sector. Due to the structural changes that were implemented, the banking sector entered a consolidation process and the weight or percentage of state owned banks, as well as SDIF banks, in the Turkish Banking System greatly declined. This in turn lead to the strengthening of the financial sector as caused by the reduction of financial risks and boost in investor confidence on the stability of the Turkish Banking System. The boost in investor confidence also had a positive impact as it

lead to the strengthening of the capital structure of the local economy and spurred the Turkish Banking Sector into a growth period at rates almost equal to what they were previous to the economic crisis. This increased growth also led to the increase in the profitability performance of private banks has improved and state-owned banks have started to generate profit thus improving the overall performance of the Turkish Banking system.

HOUSING FINANCE AND ECONOMIC DEVELOPMENT

This section of this study shall focus on the effects of housing finance and economic development. Housing finance is not neutral to economic development. There are multiple and well-known negative consequences of poor access to housing finance. On the other hand, international experience and research in high income economies shows that a well functioning mortgage market will provide large external benefits to the national economy: efficient real estate development, construction sector employment, easier labor mobility, capital market development, more efficient resources allocation, and lower macroeconomic volatility.

From the perspective of world history, urbanization is a new story and the second half of the 20th Century was marked by the urbanization take-off. What will now differentiate urbanization in the 21rst century from the past is that it will be totally dominated by urbanization in emerging markets. Most of world population growth over the next three decades will take place in developing economies and 95% of that growth is projected to be in cities. As a result, the latent demand for the efficient real estate finance systems needed to manage the production and trading of urban assets in the cities of developing economies is strong. Pressure to act is high because the lead

time for the diffusion of an already known financial innovation in a new market is often of the order of five to seven years during which city population will grow in large numbers.

So far, there has been no comparative finance work of a relatively systematic nature on the organization, structure and performance of housing finance systems in emerging markets. Even for higher income emerging economies, there are very few comparative studies. When it comes to what to do in emerging financial markets, views of mortgage market development policies remain framed by the experience of a few high-income economies; especially by the remarkable rate of innovation in the US financial markets during the last thirty years. However, in shaping a mortgage finance development strategy for an emerging market can a direct transfer of institutional arrangements found in advanced economies be readily suitable? Why is it that so many attempts to introduce mortgage securitization in emerging economies have met with so few successes?

The absence of credible comparative studies of mortgage finance systems in emerging economies might be attributed to their potential cost, the scarcity of relevant skills, the lack of private profit incentives for global investors to fund such work, and from the viewpoint of regulators to the perceived lack of systemic risks that a fragile housing finance system might create for regional or global financial markets. The situation might change for middle-income emerging economies. A new driver for more comparative analysis of housing finance systems is the potential impact of real estate assets volatility on the stability of domestic financial systems. Another one is the approval of the Basel Capital Accord II on 26th June 2004 for implementation by 2006. This

second Basel Accord is expected to have strong direct and indirect effects worldwide on mortgage finance systems through its new rules on credit risk, interest risk, and securitization that are embedded in its ' three pillars" on banking regulation, banking supervision, and financial market development.

Given that almost all the major innovations in mortgage finance have originated in high-income countries how can this technical capital be brought to bear on the design of suitable strategies to develop mortgage markets in a given emerging economy. We can expect such strategies to be shaped by two core factors: the current scale and development depth of the domestic financial markets, and the degree of organization of housing markets in the cities of the country. The aim of this paper is to map out some important structural differences between emerging markets and developed economies.

This paper first discusses five recurring structural issues that need to be considered when proposing a mortgage market strategy: market size, macroeconomic stability, the degree of development of financial market infrastructure, legal and structural path-dependency in the development of this financial infrastructure, the feasibility of domestic risk-based pricing for medium and long-term financial instruments. The second part reports recent new findings on the measurement and determinants of financial structure across some 175 countries that affect the growth of mortgage finance systems.

What are the strategic implications of these findings about the evolution of financial market structure across income levels for mortgage market development? The third part shows the impact of housing market structure on finance. The fourth part reports on the mortgage markets actually

observed in emerging economies. The last section offers observations on the development path of mortgage finance in developing economies

THE FINANCIAL CONTEXT: RECURRING ISSUES

Small Financial System

Two basic indicators of financial development are the total volume of financial assets to reflect scale and financial assets per capita to reflect financial depth. By these two measures, many emerging financial systems are quite small and shallow: they lack economies of scale and scope. Other things being equal, larger financial systems and larger banks are more efficient and more profitable than small ones for three basic reasons. A larger financial system will have lower fixed cost relative to its assets. It will have greater overall liquidity and its larger individual banks will also have less internal need for liquidity. Third, the system will be able to use its capital more efficiently through better pooling of risks without increasing the probability of insolvency and instability. For an individual bank or other financial intermediaries, a larger scale and a stronger reputation also enhance each other.

While economies of scale result from doing more of the same activity, economies of scope result from carrying out different but related activities. Financial innovation is more likely to arise in larger markets where the necessary instruments, tools and know-how are already available or can be more easily developed. The smaller a financial system, the more incomplete its range of financial instruments and services is likely to be for risk management and for funding.

The most recent year for which global comparative data on financial systems from the IMF's International Financial Statistics together with the demographic and economic structure of their economy from the World Bank's Development Indicators are available is the year 2000. This database covers 183 countries and shows that many financial systems are in fact extremely small: 63 countries had an aggregate financial sector size (measured by money supply M2) of less than USD 1 billion, i. e. no larger than a single small bank in an industrial country. These countries are dispersed around the world. Yet in aggregate these small economies represent a population over 200 million, i. e. a total larger than Indonesia, Brazil's, Bangladesh's, or Russia's population.

A higher size threshold of USD 10 billion would be of the magnitude of the balance sheet of a medium-size bank in an industrial country. We find that 115 countries still fell under this second cut-off point. These countries accounted for a population of almost 820 million in 2000. These financial systems include all of Sub-Saharan Africa except Nigeria and South Africa, some large transition economies such as Ukraine and Vietnam, a number of Latin American countries and in particular all the countries of Central America, as well as the three Baltic states in Europe.

Complementing Figure 1, Table 1 provides data on the size distribution of financial systems in 2000. Based on the value of M2, 125 countries had a financial system of $100 billion or less. Only 25 countries dominate the global financial markets. The population share of these 25 countries represented 61% percent of the world because it includes China and India. Their share of global financial assets was 95% in terms of M2, and would be

greater if better measures of net total financial assets were available. Predictably, the attention of most market analysts focuses on these 25 largest countries where the returns on information gathering and processing are positive.

As expected, comparisons based on financial depth measured in terms of M2 per capita as a proxy yield very different country groupings and rankings. One hundred countries have a level of financial depth below US $1, 000 of M2 assets per capita. Small advanced economies such as Switzerland, Singapore, Hong Kong and Luxembourg have very deep financial systems. Due to its global role as a banking center located in the middle of Europe. Luxembourg has the deepest financial system, followed immediately by the US. In contrast, India and China that ranked among the twenty largest systems drop respectively by 115 and 70 places.

Theglobalizationof financial markets does not mean that all financial systems can actually operate in a worldwide market. Licensing and regulation of banks remains a nationalresponsibility. Cross-border transactions such as deposit taking, borrowing and lending may be constrained either by regulation or by business prudence. Moreover, when it comes to small enterprises and consumer finance – including mortgage finance – small and medium enterprises (SME) and households are confined to the services of local financial intermediaries.

For the design of strategies to develop mortgage finance systems and comparative analysis it is therefore necessary to distinguish three broad tiers in the global financial system across which diagnoses, prescriptions as well

as the sequencing of reforms are expected to differ significantly. These three tiers are:

· Tier 1: Mortgage finance in very small financial systems lacking economies of scale and scope.

· Tier 2: Mortgage finance in emerging markets. This group is fairly well reflected in the Morgan Stanley " Emerging Market Index" (MSCI), which presently covers 25 very different financial systems. In 2000, their M2 scale ranged between $10 billion in Jordan and $1, 640 billion in China. Their M2 per capita depth ranged from $260 in India and $17, 100 in Israel. This second tier could include more financial systems in addition to those presently in the MSCI index. The list of the 25 financial systems included in the MSCI Emerging Market Index is provided in Appendix Table A-3. An additional list of 8 countries that could be included in Tier 2 is provided in Table A-4. It is in the Tier-2 countries that the links with mature financial markets are growing the most rapidly. Estimates from the Bank of International Settlements for 2002 show that 80% of bank loans, over 90% of foreign direct investment and over 95% of debt security issues are concentrated in these 25 countries. (See Wooldrige et al, BIS, 2003, p. 52).

· Tier 3: Mortgage finance in the high-income financial systems of North America, Western Europe, Australasia and Japan. These countries are the source of innovation, financial capital and human capital transfers in mortgage finance to developing economies. As Table suggests, 95% of global financial assets are concentrated in only 25 countries.

For the large number of small systems belonging in Tier 1, strategies to develop housing finance systems face very significant structural constraints

in terms of economies of scale for financial intermediaries and markets, the lesser degree of local competition and efficiency in services, the limited capacity for domestic risk diversification, inadequate economies of scale for regulation and supervision, without overlooking the size of the pool of human resources to manage such systems.

Some mortgage market development responses to the constraints in small domestic financial markets of Tier 1 have been:

In Africa, the development of a regional supervisory authority and of regional securities markets for both fixed-income securities and equities in the WAEMU common currency zone of West Africa with its regional central bank based in Senegal. However, the impact of these institutional efforts on the development of mortgage finance services across the countries of the WAEMU zone remains minimal.

Other approaches have been the use of currency boards for a fixed rate to a dominant regional currency such as the US dollar in Panama or the Euro for the Baltic States.

· Proposals for regional mortgage market funding arrangements for countries of Central America have not yet been able to overcome national regulatory differences and multi-currency risks, as well as heterogeneous housing market conditions.

· The creation of a liquidity facility for the small islands of the Eastern Caribbean Currency Area has also met with very slow success so far.

· Individual cross-border residential mortgage securitization issues can take place at a price, as was the case in Costa Rica in 2001 with the support of

international credit enhancements by the Dutch financial development agency FMO. Moving from such pilots to a systemic access to international funding remains to be confirmed as a sustainable strategy rather than a one time transaction.

At the threshold between Tier 1 and Tier 2, small countries such as Jordan have a financial system that is developing well. Following the model of Malaysia, the central bank of Jordan has successfully supported the creation of a liquidity facility the Jordan Mortgage Refinancing Corporation in 1996 in order to expand the competitive supply of mortgage finance by commercial banks and other retail institutions.

Macroeconomic and Financial Instability

In addition to financial market scale, another leading issue that cuts across developing economies of various sizes is their greater degree of macroeconomic instability than in high income economies.

Macroeconomic instability and its corollary of high and volatile domestic interest rates have a disproportionate impact on long-term mortgage finance. A shared regularity between mortgage finance in advanced economies and emerging markets is that interest rate risk is typically larger than credit risk for a mortgage lender. The interest rate premium over more secure US treasuries will often be high.

A variety of factors contribute to greater macroeconomic volatility in emerging markets. Their production structure is typically much less diversified than that of advanced economies and they are often dependent on primary commodities. Domestically, market segmentation tends to be greater for capital, labor, goods, and foreign exchange markets. In an

opening economy there are also transition risks including a proper sequencing of financial sector deregulation, supervision and modernization. The political economy of managing the macro-economy is also more prominent as a stability factor in emerging economies.

Given this background, triggers for a specific macroeconomic shock can be of various kinds:

Structural: wrong industrial policies and deteriorating competitiveness

Cyclical: falling commodity prices and sharp terms of trade decline

Financial: excessive leverage, weak domestic financial system, moral hazard

Developmental: inadequate management of the opening of the economy

Macroeconomic: macroeconomic imbalances, especially large and growing fiscal deficits

Global: contagion effects among global investors

The net effect of macroeconomic volatility is to generate a significant country risk premium in addition to a substantial inflation risk premium for the country debt of " emerging markets", which actually consist of a limited number of middle-income emerging economies out of the 180 economies represented in Figure 1. To the extent that a country can issue debt in its own currency there is also a significant exchange rate risk premium. The aggregate of these premia tends to spike sharply during episodes of systemic crises as show in Figure 2 that tracks the evolution of the average merging market premium over US treasuries during the last 12 years.

FIGURE 2. VOLATILITY AFFECTING EMERGING MARKETS:

Recent research shows that the real exchange rate of developing countries is " approximately three times more volatile than the real exchange rate (RER) in industrial countries" and that " there has been a much higher persistence of deviations of the variance of the RER from its long run value when the economy suffers shocks of various kinds." (See Hausmann, Panizza, and Rigobon [2004]). This is an additional challenge for the creation of robust mortgage finance systems.

Not surprisingly, many plans to develop mortgage securities markets in emerging economies face serious pricing issues in terms of interest rate levels and volatility, which negative consequences for the price of the retail mortgage loans to be funded by these securities.

However, a given emerging economy can greatly improve its position on the global financial markets over time through its demonstrated ability for sustained macroeconomic management and effective control of inflation. This is the case of Mexico today, in great contrast with the decades of the 1980s and the 1990s. (Figure 3) The effect on domestic interest rates has been quite beneficial: theMexicanprivate mortgage market that had been shut down by the financial crisis of 1995 has now reopened and the market is finally growing well in 2004.

In countries with underdeveloped capital markets, large interest rate risks have to be born by individual borrowers that do not have a comparative advantage in doing so. The spread of pension reforms and the rise of long-term institutional investors during the 1990s is a major opportunity for better risk allocation and the growth of the mortgage finance system with new

types of mortgage instruments, in particular the offer of fixed-rate mortgages instead of prevalent variable rate mortgages. Read also which helps enable an oligopoly to form within a market?

Financial infrastructure and incomplete financial systems

The last decade of research has been marked by the wide confirmation of the pioneering work done by Raymond Goldsmith [1969] regarding the positive effects of financial development on economic growth. This new research shows that the organization and structure of the financial system also plays an important causal role in the quality and rate of economic growth.

In particular, the quality of the financial infrastructure -- or rather the lack of it -- provides an explanation of why traditional banking predominates in the early stages of development. This lack of infrastructure is one reason behind the recent emergence of microfinance as a recognized, legitimate component of financial development, in addition to the low income level of the micro-entrepreneurs to be served. We expect the financial infrastructure of a country to shape the structure, organization and performance of the finance industry and the process of capital formation – and therefore mortgage market development strategies.

What is meant by financial infrastructure in the context of financial development in emerging markets? Reflecting the numerous financial crises of the last two decades in advanced economies and emerging markets alike, most financial economists now include the following components under the term ‘ financial infrastructure’

1. The legal and regulatory infrastructure:

· Financial legal and regulatory frameworks, including bankruptcy codes, enforcement, and conflict resolutions mechanisms between creditors and debtors;

· Supervision, accounting, auditing, as well as the rules, practices and professions that go with them;

· Financial corporate governance and institutions;

2. The information infrastructure:

· Public registries;

· Laws and rules about disclosures;

· Valuers;

· Credit bureaus;

· Rating agencies;

· Financial and industry analysts;

· Macroeconomic analysts;

· Timeliness, accuracy, coverage and access to public statistics

3. The risk-pricing infrastructure:

· Government securities markets

· Sub-national bond markets

· Private sector bond markets

4. The payments and settlements infrastructure:

· Clearing and settlements systems;

· Rules and standards;

· ITtechnologyplatforms;

· Networks.

5. The financial stability infrastructure:

· Liquidity facilities;

· Other safety net facilities.

From an examination of this, two points can immediately be made. First, the mere listing of these five categories of financial infrastructure is enough to suggest that bank-based systems will predominate in the early stages of financial development. Financial systems will be able to evolve from being " bank-based" to becoming increasingly " market based" as the financial infrastructure permits an increasing unbundling and the more efficient pricing of the risks underlying the supply of financial services initially provided by banks.

Second, the provision of all these infrastructure components includes a significant mix of public goods and private goods and is therefore shaped by the political economy of financial reforms. Therefore, in addition to a domestic lack of human capital and technology, the interactions between governments and domestic rent-seeking interest groups will determine what infrastructure component is going to be developed and what is going to be ignored or at least long-delayed. It often takes a crisis to create new alignments in private interests and public incentives and opens opportunities for infrastructure improvements.

Why do we expect ‘ bank-based’ financial system to dominate in emerging markets? In financial systems where the infrastructure is inadequate, traditional banks as financial intermediaries develop relationships and contracts for both deposits and loans with their clients. These contracts aim to minimize or mitigate information asymmetry problems and the associated transaction costs. To a subset of potential borrowers they offer access to funding at prices and conditions that is not feasible through non-bank finance. These banks give incentive-compatible debt contracts that give the creditor the ability to save on the costs of monitoring the borrower's performance throughout the life of the contract, and give borrowers incentives to minimize the risk of default and discourage them from hiding the true performance of their business.

A basic proposition of financial development is that this information asymmetry leads bank to engage in credit rationing. In economies with limited financial infrastructure we expect that banks will lend for trade finance and to firms with large tangible assets that can serve as collateral, which usually is real estate. Traditional banks will also exhibit a strong preference for repeat business with firms in more established activities, in better-known production sectors.

A barrier to improving and developing a solid financial market infrastructure --and indirectly to the development of housing finance -- can be the presence of an oligopolistic and politically influential traditional banking industry that is rent seeking and may successfully lobby the government to limit the entry of new financial intermediaries in order to protect high margins. In such

environments of rationed finance, established preferred borrowers may also lobby to protect their relationships with these banks.

The significance of an opaque, traditional, bank-based financial system is that the seriousness of the information asymmetry problem will tend to limit banking relationships to repeat business with mostly blue-chip customers who need to maintain their access to finance. Such a market structure can become a very important obstacle to the development of housing finance, which is characterized for banks as a business line of small-scale loans to infrequent customers, whose collateral may not be easily enforceable. Banks find it less attractive to develop lines of business for retail commodity products like mortgage loans. For these reasons government often resort to the creation of special circuits for housing finance.

Does the long list of infrastructure pre-requisites to a sound financial system condemn developing economies to a weak development of their mortgage finance systems? The analytical answer appears to be no. One important strategic opportunity to better risk management in housing finance is pension reform and the rise of institutional investors as seen during the last decade in Latin America and elsewhere. Where do you start? A suggestive answer to a workable strategy relevant to mortgage finance has been offered for pension reforms by Vittas [1998]:

"…. Consider an imaginary country that lacks all the fundamental elements of a well functioning financial system: no solvent banks and insurance companies; no mutual funds and securities markets for equities; no long-term financial instruments and annuity products; no experienced regulators and supervisors; no bankers and actuaries; no accountants and lawyers; and

no rating agencies. Should such a country reform its pension system and introduce a mandatory retirement savings scheme? Normally, my answer would be a firm no. [….]

There are, however, three preconditions whose fulfillment would allow even a country lacking all the essentials of a well developed financial system to consider undertaking systemic pension reform. These include: a strong, long-term and persistent government commitment to implement a successful pension reform; introduction of effective arrangements for the safe custody of pension fund assets (to prevent theft and misuse of assets); and free access to foreign expertise”.

Dimitri Vittas [1998], p. 2.

As the examples of mature financial systems shows, the cornerstone of mortgage finance development does not lie so much in the private sector but in this ‘ strong, long-term and persistent government commitment’ for financial reforms as shown by the on-going efforts of two very different reforming countries such as Mexico and Pakistan.

Path Dependency

The successful transfer of known mortgage finance innovations to a developing financial market requires adaptation to local institutional and financial conditions.

The comparative work on financial systems by Allen and Gale [2000] focuses only on a very small subset of five advanced economies (US, UK, Germany, France and Japan) to generate a rich set of hypotheses about why different countries have different financial systems, why these different systems came

to exist, and, whether these differences eventually matter. Allen and Gale also highlight the fact that financial systems in different countries have a tendency to maintain their core structural and organization characteristics over considerable periods time, some being more bank-based that capital-markets based for instance.

A central factor in shaping the development of a financial system appears to be the nature of the legal system. Within that context, the basic point of path dependency is that " the path of the law shapes the law." Recent work in comparative law and economics has shown for instance that different legal system may favor or hinder the development of capital markets.

In the context of global financial development, it would be myopic to limit ones attention only to simplified comparisons between countries of civil law versus countries of common law, especially when it comes to issue of real estate property. Mortgage finance systems are being developed not only under civil or common law regimes whose path dependency varies even across neighboring countries, as the difficulties in harmonizing collateral laws, regulations and practices within the Euro zone. There are countries that are influenced by Ottoman law, other forms of Islamic laws, and/or traditional tribal ownership rights. Some large countries like Indonesia may have to contend with a reconciliation of most of these legal traditions at once.