Outreach Meeting on Housing Finance in Latin America and the Caribbean

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Opening remarks

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I am really pleased and honored to open this conference on housing finance at this CGFS Outreach Meeting.

Let me take this opportunity to share with you some remarks on housing finance in Chile. Our experience may prove helpful when considering policy actions in this field.

Until the mid-seventies, housing finance was scarce and underdeveloped. There were some government programs for lower income groups and others for middle income families, but their scope and coverage were very limited. They were financed by government budgetary or social security funds. Capital markets and financial institutions were completely out of the picture.

Over the past three decades, a new housing finance industry has emerged. New players have entered the market, the volume of credit operations has increased significantly, access to services for new segments of the population has been facilitated, and interest rates and fees have declined.

This has not been a random process. It has been the result of a number of factors with reinforcing effects. Let me mention four of those factors.

The first one is **macroeconomic stability**. Economic theory and empirical evidence tell us that macro stability is a necessary condition for banking and financial development and, particularly, for the sustained availability of long term finance. This has been borne out by our experience in Chile.

We all know that macroeconomic stability depends crucially on sound monetary and fiscal policies and, in this area, the autonomy granted to the Central Bank of Chile and a commitment to fiscal discipline have both played a significant role in Chile's financial development.

As regards fiscal discipline, this has recently taken the form of a rule under which the central government must run a structural budget surplus equivalent to 0.5% of GDP. Monetary policy, on the other hand, is conducted under an inflation targeting regime. The explicit target is to keep headline inflation at around 3% with a tolerance range of one percentage point above or below the target over the policy horizon. These two institutional elements have made a major contribution to price and financial stability and, as a result, they have favored the development of housing finance.

The second factor is the **legal and financial framework** under which market-driven housing finance takes place. This includes regulation and supervision, market standards and practices, the legal regime, and the financial infrastructure. In Chile, this framework has been strengthened over time and adjusted as new circumstances have emerged. Let me give you just one example. The introduction of the inflation-indexed mortgage bond was decisive for developing housing finance at a time when inflation was still high and difficult to predict.

The third factor is the **banking system**. In most countries, including ours in Latin America and the Caribbean, banks are key players in this field. A safe and sound banking system operating efficiently seems to be a necessary condition for developing a deep housing finance market. In Chile, the banking system, whose relative strength and efficiency is widely recognized by market analysts and credit rating agencies, has been decisive in creating a mature housing finance scheme. Banks have been leaders as originators, holders of mortgage loans and providers of guaranties for mortgage-backed securities.

The fourth factor I would like to mention is the role played by the **private pension fund system**. Housing finance requires long term funding, which is a constraint in most developing countries. In Chile, the creation of a private pension fund system has played a major role in financial development and, particularly, in providing support to the housing finance industry. It has opened a new source of long-term finance for different purposes, including housing acquisition. Moreover, it has contributed to the quantitative and qualitative growth of our formerly insignificant capital market. Pension funds and insurance companies have become the major holders of mortgage-backed securities and mortgage bonds.

Nonetheless, Chile still faces a number of challenges in this field. As well as opening the access of housing finance services to new segments of the population, these include to foster greater competition, mainly in the secondary market, and to reduce transaction costs.

This meeting takes place at a time when the financial turmoil triggered by defaults on sub-prime mortgages is underway. Although it is still premature to draw any definite conclusions regarding this episode, some important issues have already been raised for discussion and preliminary policy lessons are being explored. I would like to mention some of those issues with a direct implication for housing finance.

A first key issue is the provision of services for lower income groups. This is a policy objective that must not be brought under question. The challenge to develop private finance schemes for those groups remains fully in place. Sub-prime defaults respond to causes that need to be clarified and resolved, but they should not be associated mechanically with the behavior of lower income borrowers.

A second issue is the application of external ratings. Market players have been increasingly incorporating those ratings into their investment decisions. Securities, including mortgage-backed securities, are required to get a minimum external rating to be held by certain institutional investors. The use of external ratings is attractive because of their simplicity, low cost and standardized format. However, they pose a problem as responsibility for risk management is outsourced to credit agencies. As recent experience suggests, this may create incentive problems and weaken financial discipline.

A third issue is securitization, which has received quite a lot of attention and criticism during this episode. Securitization has proven to be a strong and efficient instrument for financial development. However, it needs to be reviewed "in light of" this experience. It seems that securitization risks were not fully identified and some of them were underestimated. The "originate to distribute" model of mortgage securitization, for instance, seems to involve more risks than were previously recognized. The decision of large international banks to rescue their investment vehicles suggests that reputation risks were underestimated beforehand.

A fourth issue refers to Basel II. The ongoing turmoil has raised important questions with respect to the implementation of the new capital framework. In the so-called standardized approach, for instance, a key question is the reliance on external ratings for credit exposures and, particularly for holding mortgage-backed securities which have proven to be difficult to rate and price. Under the advanced approaches, internal models developed by banks need to be checked and adjusted or recalibrated if poor performance in this episode is confirmed as some analysts have suggested. In general, this turmoil provides a good opportunity to assess the implementation of Basel II in both developed countries and emerging economies.

These and other issues will be examined in this meeting. I hope the presentations and discussions will provide an insight into our housing finance schemes, a topic that cannot be overemphasized. The final objective is to offer policy recommendations in this field for our countries in Latin America and the Caribbean.

Thank you for your attention.