Mortgage Lending Market Development Tendencies Within the Context of Global Financial Crisis

Gunita Mazure[1], Dr.oec., assoc. professor
Faculty of Economics, Latvia University of Agriculture

Abstract. Recovery from the global financial crisis remains fragile. Persistent risks to economic health include high unemployment, debt, and low growth in developed countries, and access to financing for developing countries. Though, Latvia has started to recover from deep recession and its recovery has been recognised internationally. Crediting and especially mortgage lending is one of the aspects characterising economic and financial recovery and viability of any state. Mortgage lending is the primary mechanism used in many countries to finance private ownership of residential and commercial property. The aim of the particular research is to analyse the development of mortgage lending market in individual world countries within the context of global financial crisis. The research allowed concluding that the world financial decline of 2008 and 2009 has affected the economies of the Baltic States including Latvia more severely than the rest of the EU Member States and even the USA. The economic recession stopped in 2010, since real GDP recorded a moderate decrease (of 0.3%) after the tremendous decline of 2009 (-18%). Nevertheless, the world is still circumspect regarding borrowing and almost the same may be said about the commercial banks and their attitude towards lending.
Key words: mortgage, financial crisis, lending, interest rates, households.
JEL code: G01, G15, G21

Introduction

Mortgage lending is a special system of crediting with methods and approaches different from other types of crediting. Attraction and use of long-term resources in mortgage lending as well as trading with mortgage bonds on capital market using sales revenues to cover the necessity for long-term loans serves as the economic basis for mortgage lending system. Mortgage market development is likely to be a key factor in overall financial market development. Dwight M. Jaffee and Bertrand Renaud (1997) argue that an efficient mortgage market acts as a positive externality for the other capital markets, creating pressure for higher efficiency in these markets, while a poorly functioning mortgage market is likely to "pollute" other financial markets with its inefficiency.

In Latvia, mortgage loans became outstanding during the past decade, which may be explained by the revival of banking sector and increase of population welfare. However, the financial situation has altered for the period of 2008-2010, thus, simultaneously bringing changes in the sector of banking and crediting.

The financial crisis starting in 2008, and the important role of mortgage loans not only in the subprime crisis in the United States but also in some EU markets, has acted recently as a catalysing factor to change the traditional perspective. Mortgages and related asset classes, such as developer loans, are so large in proportion to bank assets that, as the crisis developed, the problems on some EU mortgage markets no longer remained confined to national boundaries (Dübel H.J., Rothemund M., 2011).

Mortgage lending has been analysed and discussed by different researchers (Dübel H.J., Rothemund M. 2011; Novoselova A., 2001; Jaffee D.M., Renaud B., 1997; Wyman M.O., 2005; Franke, A., Gyntelberg J., Kjeldsen K., Person M., 2004; Boyce A., 2009; Campbell J.Y., Cocco J.F., 2002; Capozza D.R., Kazarian D., Thomson T.A., 1998; Jaffee D. et al., 2003; Schwartz E.S., Torous W.N., 1992; Andrejeva V., 2005; Tirole J., 2002; Korsaks U., Adamson, A., 2001; Chiquier L., Hassler O., Lea M., 2004; Retsinas N. P., Belsky E.S., 2008; Buch J., Rhoda K.L., James Talaga J., 2002; Ijevleva K., 2011 etc.); though all of them have basically analysed mortgage lending in particular countries or mortgage lending in relation to real estate or housing aspects.

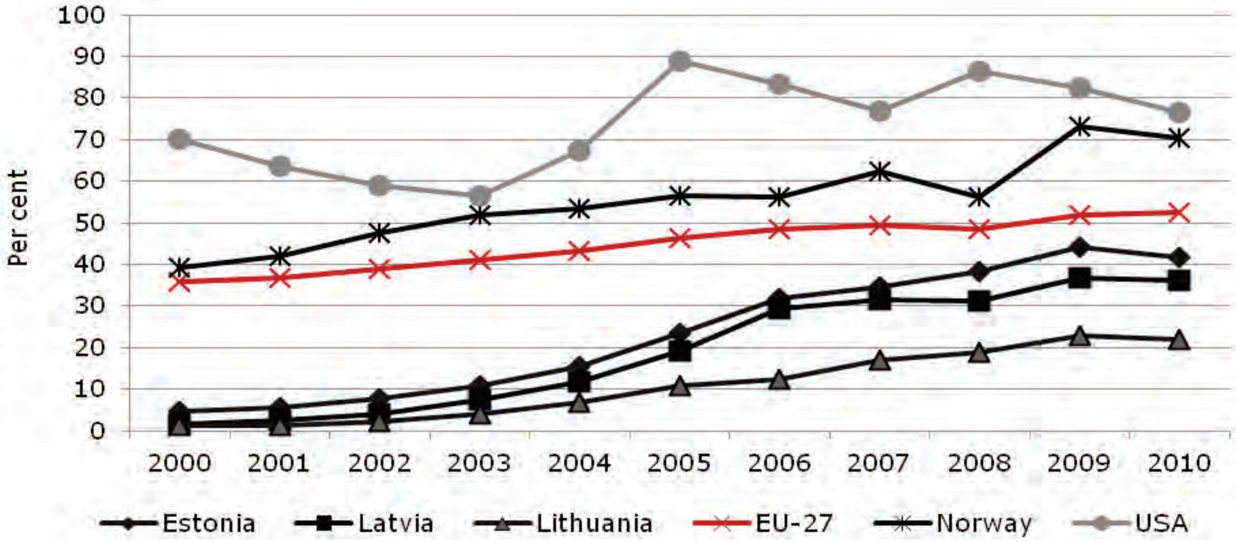
The changing situation in financial world has promoted the research on mortgage lending market and recent financial crisis. Therefore, the **research hypothesis** is that the global financial crisis has left marked traces for the expansion of mortgage lending market. The **aim of the research** is to analyse the development of mortgage lending market in individual world countries within the context of global financial crisis. The following **research tasks** have been advanced to achieve the set aim:

1) to analyse residential mortgage debt in selected world countries in relation to the changes of interest rates on mortgage loans;
2) to analyse the dynamics of mortgage lending on Latvia mortgage lending market.

The research period covers the years 2000-2010, while in case of Latvia, the period is shortened for the years 2004-2010.

The information compiled by the European Mortgage Federation, Hypostat, information compiled by the Bank of Latvia and Central Statistical Bureau of the Republic of Latvia, scientific publications of foreign and local researchers, and other materials have been used for the purpose of the study.

[1] *E-mail address*: Gunita.Mazure@llu.lv



Source: author's construction based on Hypostat, 2011

Fig. 1. **Residential mortgage debt to GDP ratio in selected countries of the world for 2000-2010, %**

The research is mainly based on the monographic descriptive method as well as the methods of analysis and synthesis are used to study the problem elements and synthesise coherencies or formulate regularities.

Research results and discussion

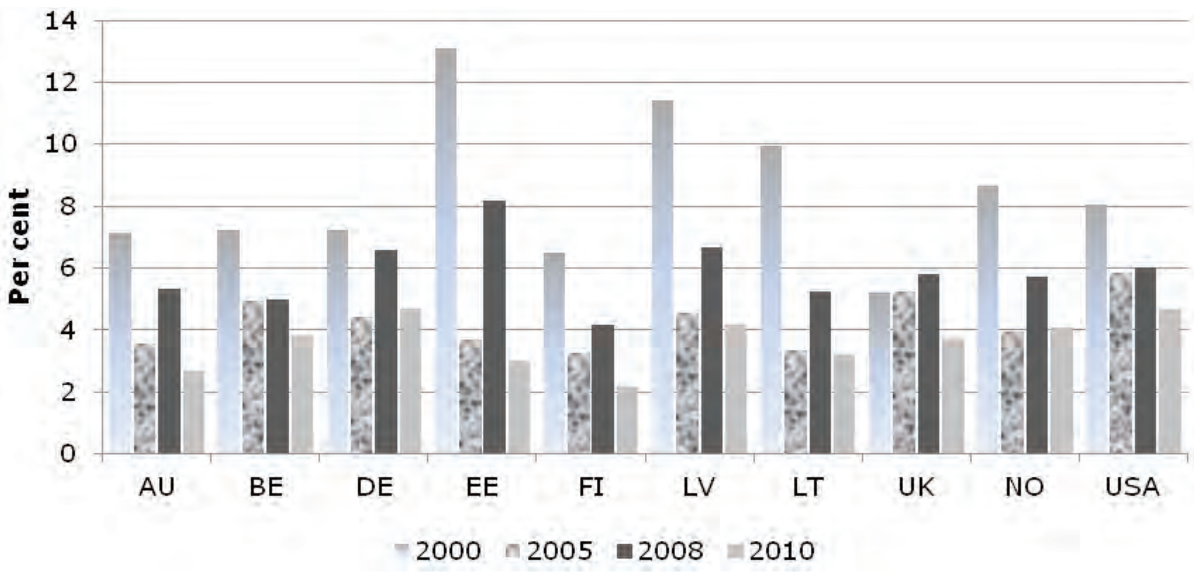
Analysis of residential mortgage debt to GDP ratio in selected world countries in relation to the changes of interest rates on mortgage loans

The financial crisis of 2007-2008 has been called by leading economists the worst financial crisis since the one related to the Great Depression and it is contributed to the failure of key businesses declines in consumer wealth estimated in the US dollars, substantial financial commitments incurred by governments, and a significant decline in economic activity. Many causes have been proposed, with varying weight assigned by experts. Both market based and regulatory solutions have been implemented or are under consideration, while significant risks remain for the world economy (Global Financial Crisis…, s.y.).

The global economic downturn of 2008 and 2009 affected the Baltic economies more severely than the rest of the EU in 2009, with no clear signs of recovery in 2010. Latvia followed this trend, although the economic recession stopped in 2010 as real GDP recorded a moderate fall (of 0.3%) after the tremendous plunge of 2009 (-18%). The huge process of deleveraging from excess households' borrowing and the prolonged downturn in the housing market after the crash of 2008 and 2009 continued to impact the Latvian economy during 2010. Government consumption dramatically fell by 11%, as did gross fixed capital formation (19.5%). As a result, domestic demand contribution was again negative, even much less than in the previous year (0.9% in 2010 against 32.2% in 2009). The economic downturn placed public finances under serious pressure, as government debt to GDP ratio went up from 9% in 2007 to 44.2% in 2010; yet, the government deficit remained above the 3% Maastricht ceiling in 2010 (7.7% of GDP) but decreased compared with 2009 (9.7%) (Hypostat, 2011). Residential mortgage debt to GDP ratio in the Baltic States, Norway, and the USA for the period of 2000-2010 is outlined in Figure 1.

The analysis of residential mortgage debt to GDP shows that the USA has been the most active borrower on the mortgage market. In 2005, the USA has reached the peak of residential mortgage debt equalling to 88.9% of GDP or showing a 32.5 percentage points increase compared with 2003. Generally, the USA shows a fluctuating trend with an increase in 2004-2005 and a decrease in 2007 and 2009-2010. Interesting that an increase of 9.5 percentage points was observed in 2008 compared with the previous year. However, the decline of the GDP amount may explain the increase of residential mortgage debt to GDP ratio. In 2010, the average residential mortgage debts of the EU-27 were about one-third that of the USA, or 52.4% of GDP against 76.5%.

Dübel H.J. and Rothemund M. (2011) have concluded that it is impossible to speak of a European model. They argue that three main categories can be distinguished within the EU, where transition countries generally feature the lowest debt ratios between 20% and 30% of GDP, with the notable exception of the Baltics (Estonia 54% of GDP, even higher than Latvia's 46%). These countries are followed by a range of 'conservative' established markets in the Central Europe with ratios between 40% and 60% of GDP. Finally, most peripheral and Northern European retail finance markets are highly leveraged with ratios between 80% and 140% (Ireland - 79%, Spain - 83%, Portugal - 84%, the Netherlands - 102%, the UK - 108%, and Denmark - 139%). In both, the first and the third category – transition countries and periphery – household debt levels have been strongly rising in the past 15 years (European Credit Research Institute statistical package 2010, see in Dübel H.J. and Rothemund M. 2011). The basic determinant of USA and European household debt



Source: author's construction based on Hypostat, 2011

Fig. 2. **Representative interest rates on new mortgage loans for the selected years, %**

levels has been a low interest rate environment, with low personal savings rates in the USA and a more varied picture in the EU.

Notably different figures, however, the same trend, are seen when analysing the data of Hypostat, which has collected information from the European Mortgage Federation National Experts, European Central Bank, Eurostat, national central banks, Bureau of Economic Analysis, Federal Reserve, and International Monetary Fund. According to Hypostat (selected data included in Figure 1), mortgage debt of Estonia was 41.7% of GDP, while it was 36.2% and 21.8% for Latvia and Lithuania respectively in 2010. The lowest ratio was for Romania – 5.6% of GDP. The highest ratio was for the Netherlands – 107.1%, Denmark – 101.4%, the USA – 76.55, and Norway – 70.3% of GDP.

In Latvia, the slowdown in lending started in early 2007, driven by concerns among foreign banks on their overexposure to the Baltic States, and at the end of 2007, growth rate in mortgage lending halved compared to what was recorded in 2006 (42.1% vs. 88.1%). As a result of the crisis, mortgage lending in 2008 grew by only 7.3%, while it went into recession for the first time in 2009, having fallen on the previous year by 4.6%. Recession in mortgage lending continued in 2010 and the same rate of decline as in 2009. Total mortgage debt as a percentage of GDP grew extremely rapidly and went from 0.7% in 1999 to the peak of 36.8% in 2009, after moving around 30% in the three previous years (Hypostat, 2011).

Interest rate developments on new mortgage loans

After the onset of the financial crisis, which followed the Lehman Brothers crash in September 2008, and also in order to contain the sharp deterioration in the macroeconomic environment, central banks made several consecutive cuts in their respective policy rates between Q4 of 2008 and Q2 of 2009 down to historical lows (Hypostat, 2011). Figure 2 shows representative interest rates on new mortgage loans for several world countries, where interest rates were available for the selected years.

In 2000, the highest interest rates on new mortgage loans were observed in the Baltic States: Estonia (13.1%), Latvia (11.4%), and Lithuania (9.93%). This is the period characteristic with high interest rates in commercial banking sector, in general. The next period or the year 2005, which is marked as the beginning of economic growth shows a sharp decrease in interest rates. In Estonia, the decline equalled to 9.4 percentage points, while Latvia and Lithuania experienced a reduction by 6.85 and 6.57 percentage points respectively. On the contrary, the interest rates grew in 2008 after the beginning of the financial crisis. Irrespective of the fact that central banks lowered the rate of refinancing, commercial banks were circumspect and increased lending rates to secure against the possible losses. In 2010, the highest interest rates on new mortgage loans stood for Latvia (4.15%) and the USA (4.69%), while the lowest rates among the analysed countries were observed in Finland (2.17%) and Austria (2.71%). Certainly, the remarkably low interest rates in Finland have boosted the development of housing market. Low interest rates, especially, on short-term loans, are based on strong consumer confidence in the economy. Interest rates in the USA, however, have not fluctuated so extremely as in the Baltic States and Norway. Thus, interest rates in the USA have stayed almost unchanged for 2006 and 2007 and showed a slight 1-percentage point decline in 2009 and a 0.35-percentage points increase in 2010 compared with the respective previous periods. The relatively stable situation for interest rates is mainly explained by the financial policy implemented in the USA. In 2010, the USA ended the worst recession since the Great Depression and most macroeconomic indicators started to indicate recovery. It is noted that interest rates on mortgage loans were on historically low levels.

Table 1

Amount of disbursed mortgage loans in Latvia for the period of 2004-2010

Year	Mortgage loans mln. LVL	% vs. the previous year	% vs. the base year (2004)	Average per one resident, LVL	% vs. the previous year	Average per one household, LVL	% vs. the previous year
2004	1392.2	100	-	602.7	100	1529.0	100
2005	2806.7	101.6	101.6	1220.3	102.5	3099.3	102.7
2006	5311.0	89.2	281.5	2319.2	90.1	5871.1	89.4
2007	7359.9	38.6	428.7	3228.0	39.2	8183.1	39.4
2008	8287.2	12.6	495.3	3650.7	13.1	9216.2	12.6
2009	7899.8	-4.7	467.4	3495.5	-4.3	8791.2	-4.6
2010	7180.7	-9.1	415.8	3191.4	-8.7	8080.9	-8.1

Source: author's calculations based on the Bank of Latvia and CSB data (2004-2010)

Development dynamics of mortgage lending market in Latvia

The assessment of mortgage lending comprises several factors influencing the growth of mortgage lending. These factors relate to various spheres of activities and differently affect the development of mortgage lending. Therefore, they may be classified into four groups consistent with the improvement of mortgage lending system:

— factors related with development of the national economy - GDP growth, development of construction and housing, real estate market, and increase of real estate prices;
— factors related with banking activities - interest rates on mortgage loans, repayment terms, availability and sufficiency of credit resources, amount of loan against the value of collateral, competitiveness among banks;
— factors related with the population welfare level – increase of population income, quantity and quality of housing, willingness of population for larger living areas and more qualitative housing;
— factors related with legislation and regulating standards - standards of Mortgage Bonds Law and other legislative and regulatory enactments, aspects of taxes and tax system, state aid programmes (Andrejeva V., 2005).

The analysis on the development of mortgage lending market in Latvia shows a rapid increase for the period of 1997-2008. The most expressive growth in mortgage lending or a twofold increase was observed in 2005 compared with 2004. Fast increase in mortgage lending was at the end of 2006 and the beginning of 2007, when the increase of mortgage loans was very high. The financial crisis of 2008 affected mortgage lending market in Latvia. Nevertheless, the situation on mortgage market was tense; it was not critical, since the demand for housing and qualitative living areas did not decrease dramatically. Thus, mortgage lending market did not ceased its operation and even starting to show the signs of recovery in 2010 and 2011. Certainly, crediting has turned to be less profitable due to the negative aspects caused by the global financial crisis and this explains also the decline of borrowings and lendings in the banking sector. Several commercial banks have stopped mortgage lending to avoid risks related with still quite unstable situation on the real estate market. These banks are occupied with the keeping of the credit portfolio quality, while other commercial banks have resumed active crediting and try to involve new clients on mortgage lending market. It shall be mentioned that the prices of housing have dropped drastically compared with the housing boom of 2007-2008 and this aspect prevents the potential borrowers from active involvement in lending market.

Table 1 includes the data on mortgage loans for the period of 2004-2010 and their comparative analysis in relation with mortgage loan amount per one resident and one household for the same period.

At the end of 2005, the amount of disbursed mortgage loans reached LVL 2806.7 million. This amount included new mortgage loans equalling to LVL 1922 million of which LVL 1207 million were aimed for the purchase of housing. Large increase of crediting was also seen in 2006, when the amount of mortgage loans grew by 89.2% compared with the previous year. Increase, though, at a lower rate, continued in 2007 and 2008; thus, reaching the amount of LVL 8287.2 million in 2008. This year is considered as a peak year for mortgage lending, since decline in crediting started from 2009 due to the financial crisis. However, for the two years of crisis, the decrease in lending is not so rapid as the increase experienced within the years of economic growth. In 2007, the speed of crediting was hindered by the government of Latvia, which undertook several measures stepping out of the anti-inflationary policy. Therefore, the amount of loans disbursed in the second half of 2007 declined by 25% compared with the first half of 2007. The growth rate related with the amount of disbursed loans continued to slow down also in 2008, when the banks implemented more secure policy of crediting and started to experience problems with attraction of financial resources. Hence, the increase was only 12.6%. An expressed decrease started in 2009 and 2010, when the amount of disbursed mortgage loans decreased by 4.7% and 9.1% compared with the respective previous periods.

The amount of disbursed mortgage loans was compared with the number of population and households. Here, the analysis showed that in 2010, the mortgage loans disbursed per one resident averaged to LVL 3191.4, meaning that every inhabitant of Latvia including small children has a mortgage debt of almost LVL 3200 on average. At the same time, each household has a debt of more than LVL 8000 on average. The figures are tremendous. Certainly, the figures are smaller by 12.6% and 12.3% compared with the peak year 2008. Unfortunately, the decline in the amounts results not only from the smaller amounts of loans but mainly to the decreasing number of population and even households.

Assuming that one household has received one mortgage loan for the purchase, reconstruction, or repair of housing, then 10.9% and 12.4% of all households had received mortgage loans in 2008 and 2010 respectively. The average loan per household equalled to LVL 8286 in 2008 and LVL 7179 in 2010. Speculative transactions were one of the reasons for such high amount of mortgage loans, while the decrease in wages affected the possibility to repay loans. In 2010, the recovery of housing market was observed in Latvia, when construction and reconstruction of housing started to overcome the collapse of 2008 and 2009. This means that different trends in mortgage lending could be noticed in the coming years.

Conclusions, proposals, recommendations

1. Mortgage lending is a special system of crediting with methods and approaches different from other types of crediting. Attraction and use of long-term resources in mortgage lending as well as trading with mortgage bonds on capital market using sales revenues to cover the necessity for long-term loans serves as the economic basis for mortgage lending system.
2. The world financial downturn of 2008 and 2009 affected the economies of the Baltic States including Latvia more severely than the rest of the EU Member States and even the USA. The economic recession stopped in 2010, since real GDP recorded a moderate decrease (of 0.3%) after the tremendous decline of 2009 (-18%). Nevertheless, the world is still circumspect regarding borrowing and almost the same may be said about the commercial banks and their attitude towards lending.
3. In Latvia, the slowdown in lending started in early 2007, driven by concerns among foreign banks about their overexposure to the Baltic States, and at the end of 2007, the growth rate in mortgage lending halved compared with what was recorded in 2006.
4. In Latvia, total mortgage debt as a percentage of GDP grew extremely rapidly and went from 1.6% in 2000 to the peak of 36.8% in 2009, after moving around 30% in the three previous years. In 2010, it decreased slightly to 36.2%. In the EU-27 Member States, the peak is still observed in 2010 amounting to 52.4% of GDP.
5. Speculative transactions and decrease in wages being one of the reasons for high amount of mortgage loans in 2008 and inability to repay loans in the following years have affected the mortgage market most severely. Though, in 2010, the recovery of housing market was observed in Latvia, when construction and reconstruction of housing started to overcome the collapse of 2008 and 2009. This means that different trends in mortgage lending could be noticed in the coming years.

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