Housing Finance Practices and Development of a Secondary Mortgage Market in Turkey

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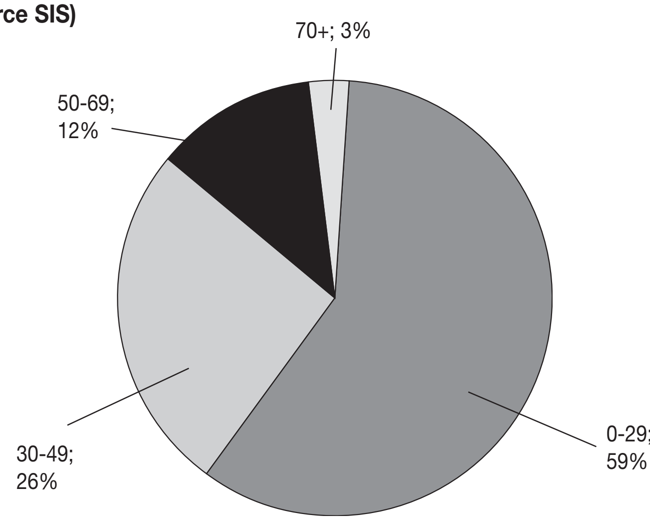
1. INTRODUCTION

Turkey, being one of the largest economies of the World, still lacks an appropriately functioning housing finance system. In the last couple of years there has been increased awareness in the public and private circles for the urgent need of cultivating a system that would alleviate the shortfalls in the Turkish economy in the housing finance front. Nonetheless, Turkey has to act swiftly to reverse the opportunity costs it has incurred to date due to the lack of such a system.

Inadequate urban planning, illegal urbanization, and chronic shortage of metropolitan residential units have produced the dominant conundrum in the Turkish real estate market. The policy choices adapted to date have been ill advised; consequently more than half of the dwelling stock in Turkey is not properly licensed. A chronic shortage of funds channeled to the housing finance market left about 40% of the existing housing stock in need of renovation. These are all inhibiting factors for an appropriately functioning housing finance system, yet they also create an immense demand for such. Given the market characteristics and existing infrastructure, Turkey is set to be one of the largest housing finance markets among the emerging economies.

Population Distribution by Age, 2003 (Source SIS)



Recent developments in the Turkish economy have created a better environment for longer-term debt and investment tools. As the government's domestic debt requirement diminishes, investors are seeking alternative tools with reasonable risk grades. Mortgage backed investment instruments have gained significant popularity in Turkey within the last 10 months. These instruments will also foster home ownership rates among the less-served households. In order to create the appropriate regulatory environment for such a market, the government has drafted a bill which would amend certain laws in order to minimize the regulatory impediments against a robust mortgage market in Turkey. Although regulatory developments are very important, they should be coupled with low inflation and interest rates and a stable macroeconomic environment.

This paper discusses the existing primary home loan market practices, the regulatory

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infrastructure, the need for a secondary market and the impediments, and the developments in housing finance market in Turkey.

2. DEMOGRAPHICS

a. Population Characteristics

As per 2003, the population of Turkey amounts to 72 million with an annual growth rate of 1.8%. The age distribution of the population signals a significant future need for new housing that would vastly surpass the levels required in the past. Approximately 60% of the population is below the age of 30. The trend towards diminishing household sizes is yet another factor that further imbalances the supply-demand equilibrium.

b. Household Income and Affordability of Housing

Income is distributed relatively unequally in Turkey where the wealthiest 20% of households receive over 50% of the income generated in Turkey. Urban households constitute only about half of the population, but earn nearly 75% of the income. This uneven income distribution signifies the fact that Turkey, being a large country in terms of population, is inhabited by a segment that is as wealthy and as large as many developed countries around the world. Annual household incomes per quintiles are given below in Table 1.

c. Dwelling Stock

Due to the earthquake in 1999 and economic crises in 2000 and 2001, housing production has significantly declined. There were two main reasons for the sharp drop in housing production figures; first of all the government temporarily ceased issuing construction and occupancy permits and secondly purchasing power of nearly 80% of the population diminished significantly.

The total number of housing units as of 2004 June is estimated to be above 17 million. This number, however, includes summer homes, second homes, and shantytowns. Hence, when analyzed in conjunction with the demographic data, there appears to be growing demand for quality housing units at an affordable price that will continue well into the future. This would add up to the existing metropolitan housing shortage of approximately 1.5 million units.

d. Home Ownership

In 2003, there were 16,070,093 households in Turkey. The most updated statistic (2000 census data) suggests that 68.2% of the total households are homeowners (10,959,803 households). 23.9% of them are leaseholders, 2.1% of them live in government housing and 4.9% of them are neither leaseholders nor own their houses. Culturally, home ownership is the most adopted means of investment. Socially, Turkish families tend to be homeowners rather than being tenants. Since institutional housing finance mechanisms do not exist, home ownership is financed mainly through family resources. Both these similar longitudinal data and other demographic analyses indicate that the typical tendency towards home ownership is disturbed towards tenancy mainly due to the lack of adequate financial structures to foster homeownership.

3. PRIMARY MARKET PRACTICES

Mortgage lending in Turkey has been mainly limited through a chronically high inflation rate and resulting high real interest rates. The high domestic debt requirement of the Turkish Treasury and adversely high interest rates offered by domestic debt instruments causes a crowding out effect in the secondary bond market. This phenomenon indirectly affects the cost of funds available for mortgage lending and inhibits growth of retail banking in general.

There is a need to provide predictable take-out financing to help spur housing production. An unintended effect of an inadequately functioning primary mortgage market is that it affects the willingness of developers to construct homeownership units, which over time, can lead to a shortage of housing units, particularly at the more affordable price points. Construction companies and developers build housing units that they know they can sell. Having a predictable source of mortgage finance, which potential homebuyers can access to purchase new units from homebuilders, helps homebuilders to construct housing.

Most homeowners in Turkey had to procure their home without resorting to mortgage lending. Less than 1% of the households had an outstanding mortgage balance. Mortgage debt outstanding was a mere

Table 1 Annual Household Income by Quintiles, 2002/03 (Source: SIS)

Quintiles	Turkey		Urban		Rural	
	2002	2003	2002	2003	2002	2003
Total	100.0	100.0	100.0	100.0	100.0	100.0
1st	5.3	6.0	5.5	6.1	5.2	6.4
2nd	9.8	10.3	9.7	10.3	10.3	11.0
3rd	14.0	14.5	13.9	14.5	14.7	15.0
4th	20.8	20.9	20.5	20.8	21.7	21.2
5th	50.1	48.3	50.4	48.3	48.0	46.3
GINI Coefficient	0.44	0.42	0.44	0.42	0.42	0.39

0.224% of the GDP in 2003, a record for the Turkish mortgage lending industry. This compares to 71% in the US and 45.7% in EU.[1]

A McKinsey and Company study claims that the mortgage market in Turkey could reach USD $20-$30 billion over time: based on a top down comparison, if Turkey's mortgages/GDP reaches 4 to 5 percent similar to other emerging countries, the mortgage market could reach US $20 -$25 billion, or alternatively based on a bottom-up estimation, if the private rental ratio drops to European levels through mortgage financing, the size of the market could reach US $25-$30 billion."[2]

The mortgage lending activity through the retail banks is illustrated in Table 2 below.

Although the target market for mortgage lending activities is assumed to be middle income families, outstanding mortgage loan amount per person suggests that these persons are mainly upper level income families. In other words, families with some amount of wealth accumulated for downpayment can receive adequate funds towards home ownership. The families in need of funds for home ownership are not able to participate in the demand side of the market as they are seldomly capable of getting involved in housing transactions. As mentioned above, such families are either tenants, live in a family-financed dwelling or in illegal dwellings.

Since lenders have to bear high risks caused by duration mismatch and do not have the means of hedging it properly, they target families with lower risk profiles. This behaviour leaves a wide segment of families underserved. This group is targeted by governmental agencies to a very limited extent but this approach is far from being adequate.

Lenders, mainly commercial banks, disburse loans at branch level. Branches take the application, conduct the real estate appraisal, check for borrower risk and underwrite the loan. Servicing could be done by any other branch of the same bank regardless of having done the origination or underwriting.

a. Products

Lenders extend loans to borrowers who wish to purchase a single-family detached/semi-detached/apartment style home. The lenders generally rely on the appraisal company's determination of the eligibility of the property subject to transaction. Some lenders have their own staff to do the appraisal.

The lenders offer a combination of Turkish Lira (TL) – denominated, and either dollar, or, Euro denominated home loans. The most popular products are fully-amortizing 36-month and 60-month loan products, although lenders will utilize pricing as a way to discourage the use of the 60-months. The average life of a typical mortgage loan

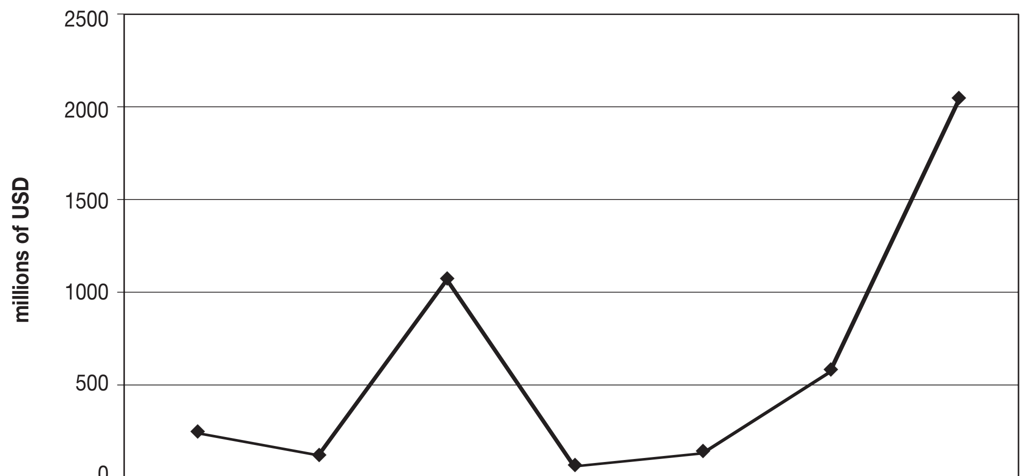
Table 2 Mortgage Lending Through Retail Banks (Source TBA)

Years	Currency Denomination	Number of Home Loans	Extended Loans (US$)	Outstanding Loans (US$)
1998	**TL**	16,591	166,008,071	107,652,583
	FX	2,001	97,833,177	88,185,452
	Total	**18,592**	**263,841,249**	**195,838,035**
1999	**TL**	9,941	70,375,791	67,687,305
	FX	645	40,668,731	73,100,092
	Total	**10,586**	**111,044,522**	**140,787,397**
2000	**TL**	55,859	828,907,297	737,521,548
	FX	2,756	245,605,886	172,589,861
	Total	**58,615**	**1,074,513,184**	**910,111,409**
2001	**TL**	2,457	12,231,509	190,936,807
	FX	454	21,015,410	53,080,172
	Total	**2,911**	**33,246,918**	**244,016,979**
2002	**TL**	9,767	80,697,328	104,490,789
	FX	1,148	76,402,961	82,309,618
	Total	**10,915**	**157,100,288**	**186,800,407**
2003	**TL**	23,305	371,117,673	384,126,263
	FX	2,694	200,710,287	188,287,412
	Total	**25,999**	**571,827,960**	**572,413,675**
2004	**TL**	96,678	1,658,601,341	1,477,227,273
	FX	3,771	362,733,234	340,280,924
	Total	**100,449**	**2,021,334,575**	**1,817,508,197**

[1] European Mortgage Federation, 2003

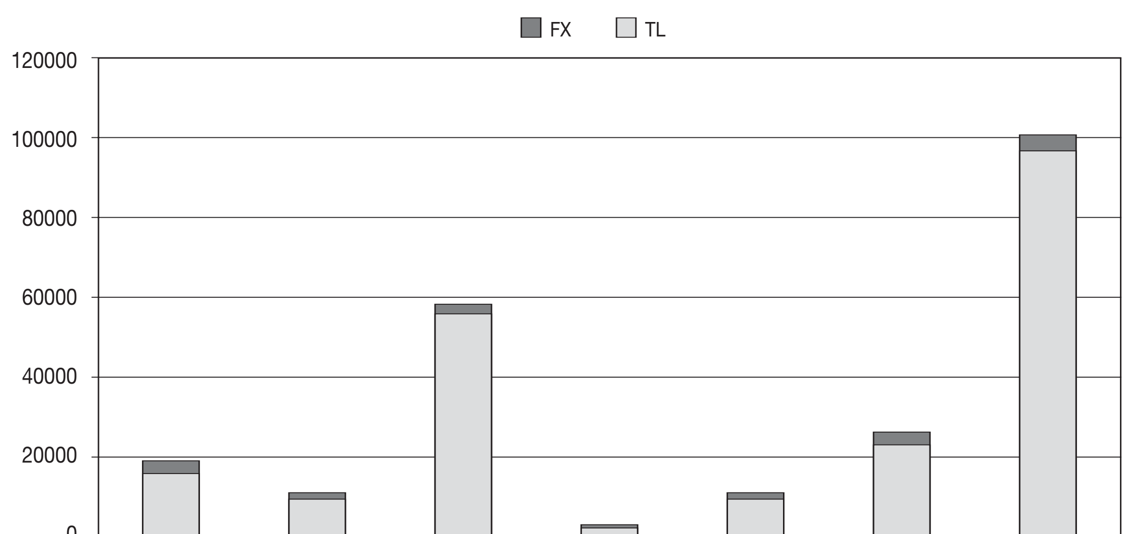
[2] "Residential Construction Report-2002." McKinsey Global Institute

Amount of Home Loans Extended



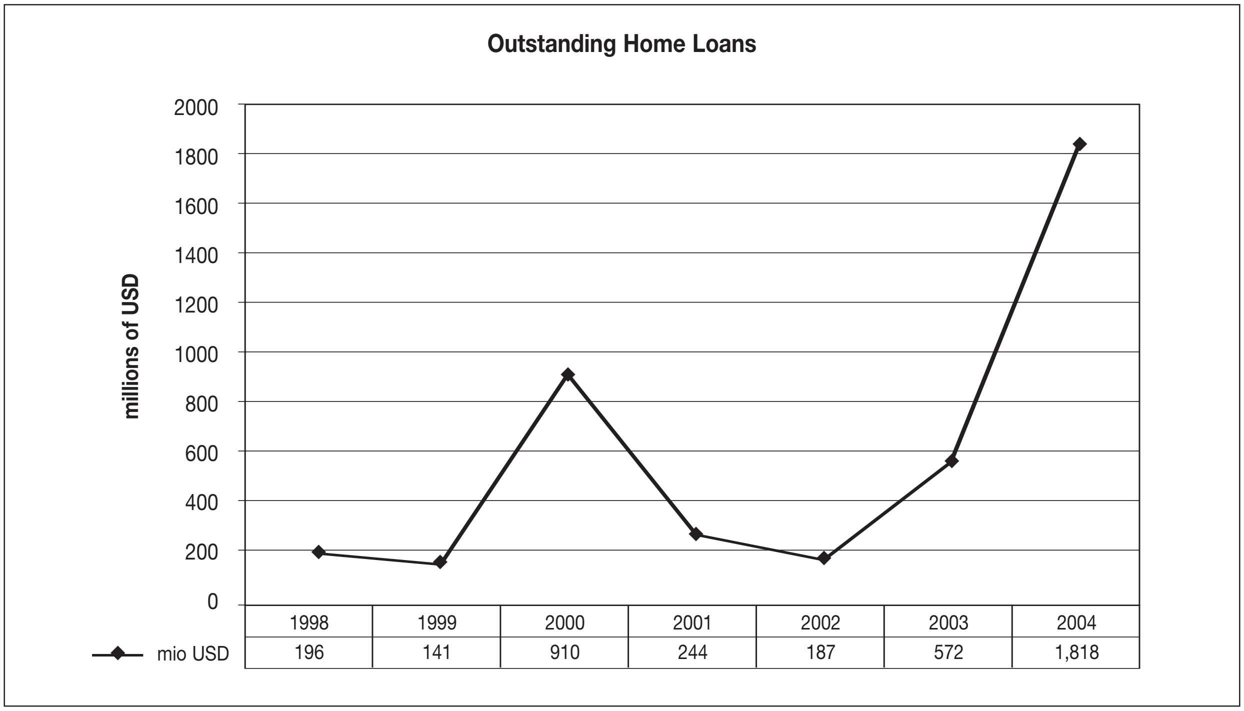
	1998	1999	2000	2001	2002	2003	2004
mio USD	264	111	1,074	33	157	572	2,021

Number of Loans Extended



	1998	1999	2000	2001	2002	2003	2004
FX	2,001	645	2,756	454	1,148	2,694	3,771
TL	16,591	9,941	55,859	2,457	9,767	23,305	96,678

years



is as short as 24-36 months due to prepayments.

Mortgage lending has been limited for a number of reasons. First, lenders are limited to providing only fixed-rate mortgages under the Consumer Law, which requires a lender to provide a borrower with the exact amount of monthly loan installments through the life of the mortgage. This requirement, in effect, prohibits the origination of adjustable-rate mortgages (ARMs). While such loans can contribute to a high default rate when rates rise, particularly with lower-income borrowers who cannot absorb the payment shock, ARMs are often used in economies like Turkey, which have had high-inflation rates. In an effort to meet market demand for ARMs, Turkish banks have been extending foreign exchange denominated loans with longer terms and better interest rates, simply because they are not allowed to extend ARMs in TL; however, this results in sizable foreign exchange liabilities being carried on their balance sheets. Foreign exchange denominated loans are quite welcome by upper level families, given a generally higher level of financial sophistication, but are not ideal for those of lower income who may not be as financially sophisticated.

Macroeconomic conditions, such as those resulting from the 2000 and 2001 crises, have had a limiting effect on mortgage originations, as can be seen in Table 3 below. High inflation rates during those crises resulted in the purchasing power of

Table 3 Current Monthly Mortgage Interest Rates (Source: Akbank, Oyakbank, HSBC, Garanti, Isbank)

	Akbank		Oyakbank		HSBC		Garanti		Isbank	
Term (years)	FX	TL	FX	TL	FX*	TL	FX	TL	FX	TL
1	0.70	1.60	0.70	1.55	0.74	1.95	0.70	1.65	0.70	1.55
2	0.70	1.60	0.70	1.70	0.74	1.85	0.70	1.65	0.75	1.55
3	0.70	1.60	0.75	1.70	0.74	1.65	0.70	1.65	0.75	1.55
4	0.75	1.60	0.75	1.70	0.74	1.65	0.75	1.65	0.80	1.55
5	0.75	1.60	0.75	1.70	0.74	1.59	0.75	1.65	0.80	1.55
5+	0.75	1.60	0.80	1.65	0.74	1.59-1.55-1.49	0.75	1.60	0.80	1.55

* There is no constant data for FX loans disbursed by HSBC. It is stated that the rate varies according to the loan amount. 0.74 is the average.

nearly 80% of the population being diminished significantly. And, because lenders are limited to originating fixed rate mortgages, they will only originate short-term mortgages only. Terms have very recently extended to 8-10 years (table 3). Lenders still seem to be serving the mortgage needs of upper income households, as families of lower income need longer repayment periods to make a mortgage affordable.

Mortgage lending has also been limited because there is no source of liquidity. Lenders are funding mortgage loans from their deposit base, and have a fundamental mis-match between assets and liabilities. Without a functioning secondary mortgage market, mortgage lenders limit their mortgage lending.

Although the maturities promoted by lenders are quite similar, there is a significant difference in interest rates. The interest rates on home loans of the largest mortgage lenders at the time of writing are provided in Table 3. Mortgage loan rates in Turkey are quoted on a monthly basis.

b. Servicing

There are multiple ways that home mortgage borrowers may repay their mortgages: via a branch, via a direct debit to their bank account, or other electronic means. At time of closing, the borrower receives a repayment schedule from the lender. It is important to note that the default history throughout many lenders is minimal, i.e. less than 1%. They sustain minimal losses to date on their mortgage lending operations, even during the crises.

c. Auxiliary Elements

For an effective mortgage market, there must be well-developed support professions that provide reliable third-party information and services to the lenders and potential homebuyers, as well as well-formed information networks, such as associations.

i. Consumer Risk

There are two main external sources of credit risk information in Turkey: The Central Bank of Turkey and Consumer Credit Bureau (KKB). Independent of the data acquired from these institutions, most of the lenders utilize their internal credit scoring systems.

Lenders also utilize certain ratios to ensure that a loan applicant's income is enough to pay the mortgage.

If the Consumer Credit Bureau/Central Bank reports are negative, the borrower has insufficient income or insufficient funds for down payment, the applicant may be denied. The Central Bank is a provider of bad credit information, where KKB offers a range of products including good and bad data of the consumer.

According to the KKB, all major banking institutions are members of the KKB. The proof of this is the fact that 95% of all consumer lending in Turkey is originated using the KKB's services. Currently, there are approximately 45 million records in the KKB's database

ii. Real Estate Appraisal Services

The real estate appraisal industry within Turkey is growing. There are currently more than 100 licensed appraisers in Turkey. The role of an appraiser is to provide a reliable estimate of the value of a property that serves as the loan's collateral. However, there is not much available data for an appraiser in Turkey to work with, as there is currently no computerized database of real estate sales prices. An appraiser inspects and investigates the subject property (for example, outstanding liens; other debt owed, such as water, sewer, or real estate taxes; and zoning issues), as well as derives valuation information from a wide variety of sources, including their own data files, property listings, and brokers or agents who are specialized in specific areas, districts, or neighbourhoods. Historical data is generally not reliable - depending upon the neighbourhood and the economic climate, (e.g. three month old data may be considered to be "old"). As a result, approximately 80% of an appraiser's work is "done on the street" because there are no computerized records.

Loan to value ratios (LTVs) are applied to the appraised value of the real estate property. Some lenders have their in-house appraisal staff and some outsource this service. In the case of in-house appraisal services, the valuation is done quite conservatively. However, LTVs in these cases go as high as 85-90%, where the in-house appraisal value is lower than the market levels. On the other hand, the majority of lenders outsource this service to certified real estate appraisal companies. In these cases, LTVs are around 60-75% depending on the lender.

iii. Insurance Services

Hazard and Earthquake Insurance is required by all lenders. This has been a requirement since 1999 and is provided by Turkish Catastrophe Insurance Pool (TCIP). TCIP takes the first loss position and private insurers take the second loss position. The annual premiums due to TCIP are collected by private insurance companies from the home owners and then forwarded to TCIP. Earthquake insurance rates are not fixed. They are determined according to the type of dwelling and the earthquake zone it is in.

Most of the lenders require that the borrower have in place a life insurance policy that would remain in effect over the term of the mortgage. Such a policy would help to cover the full repayment of the loan in the event of borrower's death. Such policies seem to be available for only one-year time horizons, even though most mortgages terms exceed one year. Hence, borrowers must renew their policy annually (at least during the term of the loan).

Private mortgage insurance services are not prevalent in Turkey. Extensive studies already conducted suggest that there is no urgent need for mortgage insurance as this will increase the cost of funds for borrowers.

Title registry offices are by far the most robust governmental institutions in Turkey. Studies conducted by banks suggest that over the last thirty years there had been only a few cases of faulty registrations, and those were due to fraud. In addition, most of the lenders re-check the building and land registries before closing on a mortgage loan. Therefore, there is no need for title insurance.

d. Key Government Participants in Housing Finance

In Turkey, there are a number of governmental agencies that have roles in the housing finance system. The key agencies are the Housing Development Administration ("HDA") and the Capital Markets Board ("CMB"). Additional regulatory agencies that have also an impact on the housing finance system include the Banking Regulation and Supervision Agency ("BRSA"), the Ministry of Finance, the Treasury, and the Central Bank.

Currently there is a draft being discussed at the parliament about establishing a secondary market institution that would buy outstanding mortgage portfolios which conform to standards of this institution, from the lenders in order to provide liquidity to the market. This act also suggests certain tax incentives and provisions from some laws such as foreclosure law. Ill-functioning foreclosure law is one of the biggest impediments towards a robust mortgage-lending program. In Turkey, foreclosure on properties of defaulted borrowers can take as long as four to five years. With the envisaged implementation of a foreclosure law coupled with a new consumer protection act, the government hopes to eliminate certain impediments and define the standards of "conforming" mortgage loans These acts are expected to provide the long expected standardization of the primary mortgage market besides liquidity.

3. Legal and Regulatory Infrastructure

a. Title and Lien Registration

Well-established property registration and foreclosure laws are essential for successful implementation of a mortgage lending system and these exist in Turkey. Currently, lien records are kept locally, at the Title Registry Office that covers the area where the property is located. In most cases, entries are made by hand. The real estate transaction is first recorded in the log journal, which keeps records of the date of the transaction. In this context, the Title Registry Office directory is the official file of the transaction. Since the transfer of the ownership and recording of the lien is done simultaneously at the title registration office, there is very little room left for human error. If any, the state is liable for mistakes made – it is responsible for recovery of losses of an owner that have resulted from mistakes made by the State.

b. Loss Mitigation and Foreclosure

"Loss mitigation" is the process a lender undertakes to work with a borrower to find alternative payment solutions to cure a delinquency.

According to Consumer Law, for a mortgage to be in default, the borrower must have missed two consecutive payments and not responded within 7 days to the written notice sent by the lender. Banking Law requires that the bank establish a loan loss reserve for all of the borrower's outstanding consumer loans after two consecutive missed payments on any consumer loan that it has originated to that borrower. This implies that if a borrower has missed two consecutive payments on a car loan, then the bank has to establish a loan loss reserve for that loan, as well as any additional credit that the bank has extended to that borrower, for example, on the home loan, even if it has been paid on-time. This regulation creates a burden on the commercial bank by causing it to keep more reserves than are necessary for performing mortgage loans. Such regulations force banks to adopt more conservative lending guidelines.

c. Bonds and Securities

The banking system in Turkey is quite developed. Although some of the banks have extensive cross border asset securitization, none has been involved in securitization of mortgage assets primarily because of limited volume of outstanding loans. In spite of adequate laws and regulations for domestic asset backed securitization, due to poor market confidence and crowding-out caused by the Turkish Treasury, these banks choose off shore placement practices. If the conditions were in favour of such domestic placements, there would still be certain restrictions on the sale or transfer of mortgage loans from one bank to another. This situation tends to favour the use of mortgage bonds over off-balance sheet methods such as mortgage-backed securities. At present the stock market is more developed than bond and fixed-income markets.

4. EVOLUTION OF A SECONDARY MORTGAGE MARKET IN TURKEY

There are a number of reasons why a secondary mortgage market has not yet developed in Turkey. Macroeconomic conditions, paired with an inadequately development capital market, seem to be the greatest inhibitors. For example, high domestic debt requirement of the Turkish Treasury and adversely high interest rates offered by domestic debt instruments causes a crowding out effect in the secondary bond market. Hence, mortgage banks have only limited access to capital market funding for their mortgages. This phenomenon indirectly affects the cost of funds available for mortgage lending and dilutes growth of retail banking in general.

As has been previously discussed, mortgage lending in Turkey has been limited by high inflation and high interest rates – two conditions requiring the design and implementation of alternative mortgage instruments. The development of appropriate primary and secondary mortgage market financing will increase the liquidity and lending capacity of mortgage lenders, increase housing affordability, and facilitate the wealth accumulation by individual households.

Mortgage lenders in Turkey are mainly commercial banks. Funding for mortgage loans is done through savings deposits. The average term of savings deposits is less then two months. Therefore, even mortgages with 5-8 years maturity create an enormous amount of risk load on banks' balance sheets. Secondary markets will provide the long-term funds required to disburse longer-term mortgage loans at the primary market level.

Currently there is a draft being discussed at the parliament about establishing a secondary market institution that would buy outstanding mortgage portfolios, which conform to their standards, from the lenders in order to provide liquidity to the market. The suggested secondary market entity will assume some conduit (Fannie Mae-like) functions and some other functions of FHLB, VA and German mortgage banks. This institution is expected to provide standardization to the primary market.

This act also suggests certain tax incentives and provisions from some laws such as foreclosure law. Foreclosure law is one of the biggest impediments towards a robust mortgage lending program as with the current implementation of this law coupled with the new consumer protection act, foreclosure on properties of defaulted borrowers can take as long as four to five years. By eliminating certain impediments and defining the standards of "conforming" mortgage loans, this act is expected to provide the long expected standardization to the primary mortgage market besides liquidity.

Tax exemptions, faster foreclosure procedures, exemptions from consumer protection law and some other incentives and exemptions are also defined in this draft.

Most important of all, the new draft will enable the lenders to extend ARMs despite the consumer protection act.

5. CONCLUSION

There is a tremendous expectation for a robust mortgage market to be up and running in Turkey. All the players are putting a lot of resources into this development. However, for a mortgage lending system to be as effective as it is in western economies, first of all, macroeconomic stability should be achieved. Secondly, until all the elements of a robust mortgage system is adequately in place, "mortgage lending" practices should be implemented on housing development projects as "pilot programs". This approach would enable the lenders to create homogeneous pools of mortgages. On the other hand, minimizing the cost of land for housing development purposes through proper regulation and utilization of state owned lands would play a crucial role in making housing more affordable, at least until a robust domestic mortgage market is in place. Thirdly, a local investor appetite towards mortgage-backed bonds should increase. This appetite is expected to increase as the crowding out effect in the domestic bond market diminishes in the short run. Finally, regulatory infrastructure should be in place. In other words, in order to eliminate certain legal impediments, certain laws, such as the tax laws, consumer protection law, foreclosure law, etc have to be amended. These amendments are expected to be in effect within 2005.

Until the above-mentioned prerequisites are met and a domestic secondary market is evolved, lenders may choose to utilize funding their mortgages through cross border placements.

Buyer's equity (down payment) plays a crucial role for affordable monthly payments. Housing savings fund systems is one of the methods to help the buyers raise equity shares. There is a law of incorporation for a housing savings fund issued by Housing Development Administration in 1995 in place without secondary regulations necessary for implementation. Housing finance through savings funds support the primary market in reaching a volume where secondary market transactions would fit the economies of scale.