Guarantee Funds: An International Perspective

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Introduction

International interest in guarantee systems in housing finance markets is growing. This development can be seen as an outcome of discussions in a number of countries on how to improve the functioning of housing finance and housing markets in the context of promoting home-ownership. Supply-side government intervention by way of creating guarantee funds has proved to be an effective and efficient way of increasing the accessibility and affordability of housing markets. Some funds are also designed to provide credit enhancement as a facility to develop the secondary mortgage market.

Today, several countries all over the world have set up, or are in the process of developing, guarantee systems which are mostly structured by government support. In the Netherlands, there is a long history of stimulating home-ownership. In the social rental sector, as well as the owner-occupied sector, two government backed guarantee funds are currently in operation. The experience of the Dutch guarantee system may be useful to other countries, for example, those which have recently entered the European Union or are planning to do so. Of current interest in this respect is the question of whether this may result in the creation of a ladder of opportunity, ie, from a subsidy oriented to a property ownership/security oriented system as has been evident in Dutch housing policy.

Against this background, three Dutch organisations (Bank Netherlands Municipalities, Foundation Social Housing Guarantee Fund and Foundation Homeownership Guarantee) decided to carry out a study using an international survey (NHG, 2004). The aim of the study was to consider how the different schemes were working and through that to show policymakers and others the types of guarantee systems that exist in the various countries and the ways they contribute towards the effective functioning of mortgage and housing markets. The study was done by the research bureaus Onderzoeksinstituut OTB and Rigo Research & Advice.

The study investigated both the rental and owner-occupied sectors, but this article is concerned only with the owner-occupied sector and indeed with the primary mortgage market. Although this study was based on an international comparison, no efforts were made to answer the question of what the best guarantee system would be.

The Survey

The twelve countries described in the study are:

Inside Europe:
- Netherlands
- Belgium
- Denmark
- France
- Germany
- Lithuania
- Slovak Republic
- Sweden
- United Kingdom

Outside Europe:
- Japan
- Canada
- United States

Germany and the UK are different to other countries in a sense that they do not have central government backed guarantee systems. Germany does not have a full national scheme, whereas, in the UK, private mortgage insurance products are the norm (though Scotland has recently introduced a government backed mortgage 'rescue' scheme). Some of the countries, like the USA, consider home-ownership to be a central focus whilst in other countries policy is tenure-neutral. In general, the main issues in all the countries are about improving availability and affordability.

In some countries, the mortgage guarantee has been developed as the main instrument, thus replacing interest subsidies and government loans as an alternative strategy. This development could be seen as the result of shrinking government budgets, a more efficient way of allocating capital and changing opinions regarding government intervention in the market mechanism.

Differences in design and risk profile

The structure of guarantee funds varies across countries with both government 'owned' institutions and privatised organisations being apparent. Government 'owned' includes guarantee funds in the USA (albeit privatised but with an implicit

Table 1: Fee Structure, Government-backed guarantee funds

	Neth	Bel	Can	Fr	Lit	Sw	USA
Upfront or per annum (p.a.)	Upfront	n.r.	Upfront	Upfront and p.a.	Upfront	p.a.	Upfront and p.a.
Differentiation	n.r.	n.r.	LTV	n.r.	LTV	n.r.	n.k.
% of loan	0.28	0	0.5-4.5	2.0 Upfront 0.15 p.a.	Max. 4.43	0.5	1.5 Upfront, 0.5 p.a.
Premium paid by	Borrower	n.r.	Borrower	Bank and government	Borrower	Borrower	Borrower

Source: country studies; n.r.: not relevant; n.k.: not known

guarantee), Canada, Lithuania, Sweden and the Slovak Republic.

The position of the Homeownership Guarantee Fund in the Netherlands, as a private foundation providing guarantees for the primary mortgage market, is unique. This fund is the successor of the Municipal Guarantee in operation from 1956 to 1995. As of 1995, the guarantee system was redefined and was set up as a private non profit fund with close ties to the government. Annual adjustments to the guarantee terms and standards need the approval of the central and local government.

In risk management, most funds show a range of risk cover from a 100% guarantee for both loan and transaction costs, to only a part of the loan amount. In most countries, fees are the main source of earnings to build up reserves to cover the credit risks of mortgage loans. Typically, profit related prices do not play any role in government backed guarantee systems. So what concerns such guarantee systems is an actuarial fair cost price based risk premium to meet default losses under volatile economic circumstances. Due to different economic stages and different housing policies among countries, various risk profiles affect the form and extent of the premium.

All funds collect premiums ranging from a single up-front fee in the Netherlands, to a combination of a single up-front fee and annual payments. Belgium's guarantees are free and in France the single up-front fee is paid by participating lenders and the government. French lenders pay an annual premium on top of the up-front fee. Table 1 shows what has to be paid to the several guarantee funds.

Criteria

The assessment procedures, which are followed by all guarantee funds in the study, state that borrowers have to meet a number of criteria of which the home purchase cost-to-income ratio, loan-to-value ratio and the earnings conditions are the principal ones. Sometimes the interest level is a crucial issue in the size of loan amount. These qualifications differ among the described countries. In Belgium, guarantees are based around a set of maximum income level and maximum price level. The Dutch regulation has been built on a combination of a maximum loan amount and a maximum house price dictating the guarantee loan amount. The French guarantee system is open to borrowers who are eligible for a subsidy. Sweden's guarantees are granted only for new housing. Lithuania does not seem to have strict rules regarding income, house prices and loan limits. Some countries do not allow borrowers to freely decide to take a guarantee or their options may be limited. In the USA, Canada, France, UK and Lithuania, each mortgage loan exceeding a loan-to-value of 80 % respectively 75 % requires a (public) mortgage insurance (Table 2).

Table 2: Maximum loan-to-value with and without government guarantee or private insurance

	Public/private guarantee funds							Private insurance		
	Bel	Can	Fr	Lit	Neth	Sw	US	Can	UK	USA
Max. LTV without guarantee	100	75	60	70	>100	95	78	75	70	78
Max. LTV with guarantee	100	95	100	95	112	95	97	95	100	100

Source: European Central Bank (2003)

Table 3: Costs and benefits for a €100,000 mortgage of a guarantee/insurance for a home-owner

	Government-backed guarantee							Private insurance		
	Bel	**Can**	**Fr**	**Lit**	**Neth**	**Sw**	**USA**	**Can**	**UK**	**USA**
Costs	0	3,250	0	4,430	280	2,043	3,565	3,315	1,600	3,221
Interest discount (basis points)	130	46	75	100	30	n.k.	35	46	20	35
Interest discount	8,680	4,667	5,107	6,993	2,159	n.k.	2,933	4,667	1,990	2,993

Source: Survey

Comparison of cost and benefits for home-owners

By creating government supported guarantees, it is of crucial importance to have the full trust and financial support of the government for the long term. The success of such systems also depends on the attitude of lenders. In fact, the system can only work satisfactorily when it generates added value to lenders. For example, for a guaranteed loan under the National Mortgage Guarantee scheme of the Homeownership Guarantee Fund in the Netherlands, lenders are not obliged to build up reserves on their balance sheets. Mortgage loans connected to this so-called zero solvency ratio result in lower funding costs. In the case of competitive markets, for example the Dutch market, mortgage lenders are passing these lower capital costs onto borrowers. In terms of basis points, borrowers benefit up to 50 basis points. The benefits for borrowers are difficult to compare in an international study. Both research institutes have tried to compare the benefits and costs from a borrower's point of view. One way of doing so is by expressing costs and benefits in the present value method. Table 3 presents the costs and benefits for a home-owner.

In terms of costs, borrowers in Belgium and France have nothing to pay while costs are the highest in Lithuania. Dutch borrowers are third best off, only having to pay a single up-front fee of €280 for a mortgage of €100,000 in 2005. In Canada, the USA and Lithuania, direct costs are considerably higher. This might reflect a substantially higher risk profile in these countries. In terms of the value of the interest discounts, the ranking is rather different.

Conclusions

Guarantee funds are instruments to improve the affordability and accessibility of the housing sector. Through their economies of scales, guarantee funds can obviously manage credit risks better and more efficiently than individual lenders. We argue that government backed guarantee funds can help housing policies to successfully and effectively influence economic welfare, more so than commercial insurance organisations. As the international survey shows, all government guarantees have different structures, especially when markets require their own equity guarantee funds, which will stimulate the working of the mortgage markets. By getting a higher volume of mortgages, demand for housing will increase. Of course, the effect depends on the market share of the government backed guarantees. The market share differs among countries and is very small in Sweden and Belgium. In our view, countries considering options on how to promote home-ownership could find the experience of all operating guarantee funds very helpful and readers are very welcome to contact the Dutch home-ownership guarantee fund for advice (www.nhg.nl).

Reference

National Hypotek Guarantee (2004) Government Guarantees in the Rental and Owner-Occupied Sector: An International Comparison 2004, Part 3, NHG Series and published by Foundation Homeownership Guarantee Fund, Bank Netherlands Municipalities and Foundation Social Housing Guarantee Fund, Po Box 309, 2700 AH Zoetermer, The Netherlands.