HOUSING FINANCE IN TURKEY: THE ROLE OF HOUSING LOANS EXTENDED BY COMMERCIAL BANKS

A THESIS SUBMITTED TO
THE GRADUATE SCHOOL OF SOCIAL SCIENCES
OF
MIDDLE EAST TECHNICAL UNIVERSITY

BY

ŞADİYE AYDIN

IN PARTIAL FULFILLMENT OF THE REQUIREMENTS
FOR
THE DEGREE OF MASTER OF SCIENCE
IN
THE DEPARTMENT OF
URBAN POLICY PLANNING AND LOCAL GOVERNMENTS

DECEMBER 2006

Approval of the Graduate School of Social Sciences

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ABSTRACT

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December 2006, 158 pages

With the 1980s, as a result of economic and financial deregulation policies, housing finance systems in most countries have had great transformations and have become market-oriented. Recently, in Turkey, a draft law was submitted to the parliament which can be regarded as an attempt to integrate housing finance to capital markets through the establishment of secondary market for housing loans extended by commercial banks. In this thesis, it is aimed to evaluate the role of housing loans extended by commercial banks on housing finance in Turkey, to assess the prospective legal regulation in terms of lenders and borrowers of housing loans and to discuss the anticipated impacts of this scheme to the commercial banks, the housing loans and borrowers within the context of global trends in housing finance. For these purposes, housing files extended by commercial banks have been examined and in-dept interviews have been conducted with interviewees from commercial banks, Capital Market Board and Housing Development Administration. As a result, it is found out that the role of housing loans extended by commercial banks is very limited in housing finance in Turkey and only high income groups can access these loans. Moreover, it is explicit that the housing finance scheme in the draft law is entirely market-oriented and targets the middle and upper income groups. On the other hand, such a policy orientation is quite problematic and paradoxical in that; the housing problem in Turkey is most dramatically felt by the lower middle and low income groups.

Keywords: Housing Finance, Housing Loan, Commercial Bank, Primary Market, Secondary Market

ÖZ

TÜRKİYE'DE KONUT FİNANSMANI: TİCARİ BANKALARCA VERİLEN KONUT KREDİLERİNİN ROLÜ

Aydın, Şadiye

Yüksek Lisans, Kentsel Politika Planlaması ve Yerel Yönetimler Bölümü

Tez Yöneticisi: Doç. Dr. H. Tarık Şengül

Aralık 2006, 158 sayfa

1980'lerle birlikte, ekonomik ve finansal deregulasyon politikalarının sonucu olarak birçok ülkede konut finansman sistemleri büyük dönüşümler geçirmiş ve piyasa-odaklı hale gelmiştir. Yakın geçmişte, Türkiye'de, ticari bankalar tarafından verilen konut kredileri için ikincil pazar oluşturulması yoluyla konut finansmanının sermaye piyasalarına eklemlenmesi girişimi olarak değerlendirilebilecek bir kanun taslağı parlementoya sunulmuştur. Bu tezde, Türkiye'de konut finansmanında ticari bankalar tarafından verilen konut kredilerinin rolünün değerlendirilmesi, beklenen yasal düzenlemenin konut kredisi alanlar ve verenler açısından değerlendirilmesi ve konut finansmanındaki küresel trendler çerçevesinde bu tasarının ticari bankalar, konut kredileri ve kredi alanlar için muhtemel etkilerinin tartışılması amaçlanmıştır. Bu amaçlarla, ticari bankalar tarafından verilen konut kredileri dosyaları incelenmiş ve ticari bankalar, Sermaye Piyasası Kurulu ve Toplu Konut İdaresi Başkanlığı'ndan görüşmecilerle derinlemesine mülakatlar yapılmıştır. Sonuç olarak, Türkiye'de ticari bankalar tarafından verilen konut kredilerinin konut finansmanındaki rolünün çok sınırlı olduğu ve sadece üst gelir grubunun bu kredilere ulaşabildiği anlaşılmıştır. Ayrıca, kanun taslağındaki konut finansman tasarısının tümüyle piyasa-odaklı olduğu ve orta ve üst gelir gruplarını hedeflediği çok açıktır. Diğer taraftan, Türkiye'de konut sorunu en dramatik biçimde alt orta ve alt gelir grupları tarafından yaşanıldığından böyle bir politika yönelimi oldukça problemli ve çelişkilidir.

Anahtar Kelimeler: Konut Finansmanı, Konut Kredileri, Ticari Bankalar, Birincil Piyasa, İkincil Piyasa

To My Dear Sister Gülhizar;

For her moral and financial support during my education.

ACKNOWLEDGMENTS

First of all, I would like to express my sincere gratitude to my supervisor Assoc. Prof. Dr. H. Tarık Şengül especially for his guidance, patience and insight in my troublesome thesis writing period. I would like to thank to Prof. Dr. Melih Ersoy and Instr. Dr. Bahar Gedikli for their suggestions and comments.

I would like to thank to my colleagues, especially to my manager Aykut Arslan, for their encouragements during my thesis writing period. I am grateful to the interviewees from Capital Market Board and Housing Development Administration and bank employees who made invaluable contributions to this thesis. Special thanks go to Erhan Şatana for his precious support as a friend and a colleague during this study.

I offer my deepest gratitude to my dear family for their endless support and love. I would like to thank to my brother, Mehmet who corrected the manuscript of this thesis and my sister, Gülhizar for her comments in terms of legal regulations as a lawyer.

Lastly, I do not only express my endless gratitude but also my deepest love to my husband, Tayfun who motivated and made me feel better during my frustrated times. Thank you for sharing the life with me.

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CHAPTER 1

INTRODUCTION

Housing is accepted as a fundamental right in the international arena according to the Universal Declaration of Human Rights (1948). Moreover HABITAT II Conferences organized by United Nations have underlined the importance of housing with a main theme of UN Habitat Agenda as “enough housing for everyone” (Habitat II, 1996)

In Turkey, the Constitution (1981) regulates the housing issue in article 57 as "The State shall take measures to meet the needs of housing within the framework of a plan which takes into account the characteristics of cities and environmental conditions and shall support mass housing projects."

However, like in other developing countries, housing is a major problem in Turkey. In very general, authorized-housing shortage in urban areas[1], unqualified housing stock with poor conditions, and affordability of housing are the main issues related to housing problem due to the rapid urbanization and high population growth. In addition to these, unequal income distribution, insufficient capital accumulation, lack of financial resources which can be allocated to housing due to high inflation rates and high budget deficits and earthquakes make the housing problem worse in our country.

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[1] In 2002, a research report about the housing need in Turkey for 2000-2010 period was published by the Undersecretariat of Housing. In this report, it is stated that there is an authorized housing deficit in our country although it seems that there is a housing stock surplus in total according to the 2000 census data. The main reason for this surplus is stated in this report as the inclusion of unauthorized housing to total housing stock. See Konut Müsteşarlığı, 2002 for further details.

In Turkey, housing policies implemented by the governments in power until now are far from being comprehensive and consistent in dealing with the housing problems. In the following, the housing policies will be briefly discussed in three periods which have totally different perspectives on housing issues.

In the first period (from beginning of 1920s to the end of 1940s) which can be characterised by the process of formation of the nation state with the foundation of republic, housing was mainly evaluated in the context of 'housing issues of the state' such as providing necessary housing for the civil servants. In the second period (from beginning of 1950s to the end of 1970s) urbanization process had the greatest role and housing was assessed in the context of 'housing issues of the labour' such as squatter building as the labour side solution of the housing problem and support of social housing as the state's solution. In the third period (from the beginning of 1980s) in which the capital accumulation process has been the main perspective in the building sector 'in order to achieve economic development and growth'. The housing has been evaluated in the context of 'housing issues of the capital' such as housing construction as a profitable economic activity for the capital.

In the first period, housing has begun to be considered as a problem to be solved with the foundation of the republic and declaration of Ankara as the capital city. Although renewal of the settlements damaged during the wars and housing the migrants could also be regarded as housing issues, housing the civil servants were the basic issue in this period. Housing policy of the state was mainly focused on the sheltering problem of civil servants[2] in Ankara, the new capital city. During 1920s, certain policies were implemented in order to deal with this problem such as advance payments to civil servants for the establishment of housing cooperatives and housing allowances[3] (Keleş, 1990, Alkışer and Yürekli, 2004)

[2] Namık Kemal (Saraçoğlu) district can be given as an example of housing project for the civil servants. (Alkışer and Yürekli, 2004)

In the second period, especially in the beginning of 1950s housing has become the problem in whole country, because migration from rural to urban gained momentum as a result of increasing employment opportunities in cities. Industrialization efforts in the big cities, in addition to the mechanisation of agriculture in rural areas had accelerated the urbanization which led to housing problems for the labour migrated from rural to urban. The housing problem was tried to be solved by the newly urbanized labour with squatter housing as the cheapest way of sheltering. In 1950s the prevention of squatter building was the main theme of the housing policies.[4]

In 1960s with the acceptation of 1961 Constitution which was mentioning 'the satisfaction of housing need', the planned period started in which the housing was regarded as a social right to be provided by the state with a great emphasis on social housing. In all Five Year Development Plans implemented in this period, the main goals were nearly the same; producing more houses with the limited resources, limiting the production of luxury houses, producing houses for low income groups, preventing land speculation by providing cheap land, supporting the social housing, preventing squatter building, solving the land ownership and infrastructure problems of squatter settlements. The social housing was supported by the state and housing credits for social housing were provided by the state-owned institutions such as Social Security Organization (SSK[5]) and Emlak Bank. The other main feature of this period was that, the housing investments especially for the luxury housing were regarded as inefficient investment compared to industrial investments (Keleş, 1997). Since the aim was use of limited capital for the rapid industrialization.

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[3] Certain Laws related to these policies are 586 (dated 1925), 1352 (dated 1928), 1452 (dated 1929) and 4625 (dated 1944) (Keleş, 1990)

[4] Certain Laws related to prevention of squatter building in this period are 5218 (dated 1948) and 5228 (dated 1948), 6188 (dated 1953) and 7367 (dated 1959) (Keleş, 1997)

[5] Sosyal Sigortalar Kurumu

Nevertheless, the housing problems in this period continued with an enormous increase due to the continuing rapid urbanization and population growth in cities. On the one hand, squatter building gained momentum as the solution of the labour side which was fuelled by policies implemented such as issuing pardons/amnesties for the squatters[6]. On the other hand, necessary social housing as the solution of state emphasized in Five Year Development Plans in order to satisfy the housing need of the urbanized labour could not be provided due to the lack of required funds to be devoted in housing as a result of insufficient capital accumulation.

The third period has started in 1980s and parallel to the global trends, housing policies of the state have changed in Turkey. In this period, 'positive effects of housing on urban economy' has been discovered by both the state and the capital. The understanding that 'housing investments were inefficient compared to industrial investments' has totally changed and building sector[7] especially housing construction has started to be seen as the leading sector in order to achieve economic growth. In this period the main arguments were; building sector must have been supported because it has created employment opportunities for unqualified labour in urban areas, has activated trade and has revived local economy. In addition to these, the use of mainly domestic inputs in building sector which meant less capital outflow due to the limited import has been one of the popular arguments stated as the advantage of building sector in Turkish economy.

In this period, as a result of mass housing projects and renewal of squatter areas, building sector has been able to make profits from construction basically from the

[6] The Squatting Law (Gecekondu Yasası) dated 1966 number 775 legalized both the process of squatter building and the squatter housing. (Keleş, 1990)

[7] In Turkey the building sector mainly consists of two actors as "large-scale housing enterprises using advanced technology" and "petty producers (Yap-Satçı) who construct a maximum of several buildings annually". (Keleş, 1990:170) However, since the discussions related to this classification and these actors are out of our concern in this thesis, these two group of actors will be called totally as building sector despite it may be regarded as oversimplification.

housing. The housing policies in 1980s have been focused on mass housing projects (Tekeli, 1995) which have been supported financially by the state through certain institutions such as Housing Development Administration (TOKİ[8]) and Emlak Bank. Starting with 1990s the renewal of squatter areas has been aimed in housing policies of the governments in power which can be regarded as another area of urban rent for capital. Indeed, it can be argued that housing policies in the third period have mainly aimed the capital accumulation in building sector 'to fuel the economy'.

Consequently, housing policies of the state and implementations of the governments related to these policies in our country have been inadequate both in the solution of the existing housing problems and prevention of the forthcoming potential problems related to housing.

Although homeownership is not the unique solution for satisfaction of housing need, lack of social housing for needy families, lack of rent controls and high rents for rental housing compared to income levels force people to own their houses.

However, housing is the most expensive consumption item in households' budgets. In order to purchase a house a considerable amount of funds is needed. If people choose to accumulate these funds it will take a long time to reach the amount required. Perhaps, some of them will not be able to buy a house during their life-span since the real value of their savings may diminish due to the inflation (Boleat, 1985). Hence, it is very clear that borrowing is the core of financing a house and there must be 'lending of funds' in order to 'borrow' which points to the necessity of a housing finance system.

Turkey lacks a comprehensive institutional housing finance system. Neither the state nor the market itself has achieved to develop a functioning institutional

[8] T.C Başbakanlık Toplu Konut İdarisi Başkanlığı

housing finance system. Currently, commercial banks are the only institutional housing loan providers except TOKİ. On the other hand, like in other developing countries, people mainly finance housing with the funds borrowed from the relatives or purchase housing with instalment sales made by developers who aims to finance building costs during the construction period (Rocha, 2000)

Recently, housing finance has become one of the most popular topics in Turkey with the submission of a draft law named "The Draft Law Amending the Laws Related to Housing Finance System" to the parliament known by the public as 'mortgage law' which regulates the legal framework for the housing finance. This draft law can be regarded as an attempt to provide the legal framework for both the lenders and borrowers of housing loans in the primary mortgage market and establish a secondary mortgage market in order to integrate housing finance to capital markets as a reflection of global trends in housing finance. Since housing finance all over the world have had radical transformations and global trends such as decline of special circuits in housing finance, increasing share of commercial banks as a result of erosion of specialist housing finance institutions and the integration of housing finance to capital markets through secondary mortgage market facilities have occurred in housing finance (Renaud, 1999).

In this thesis, it is aimed both to evaluate the role of housing loans extended by commercial banks on housing finance in Turkey and to assess the prospective legal regulation namely the draft law in terms of lenders and borrowers. Another objective of this study is to discuss the anticipated impacts of this housing finance scheme to the commercial banks, the housing loans and borrowers within the context of global trends in housing finance.

Since 1990s, it is mainly argued that the legal and institutional framework for housing loans should be revised and integration of housing finance to capital markets through secondary market for housing loans should be achieved (Alp, 1996; Uludağ, 1997; Teker, 1996; Özsan and Karakaş, 2005) in order to develop the institutional housing finance mechanism in Turkey. However, the question of "for whom" is essential, since there is no doubt that such an entirely market-based housing finance system will exclude some income groups. Therefore, the basic hypothesis of this study is that; neither the housing loans extended by commercial banks nor the draft law's housing finance scheme target all income groups. Low and moderate income groups seem to be totally excluded of the system and the housing finance policies for these excluded income groups should be developed separately which are out of this thesis concern. It would not be unfair to argue that this scheme targets the middle and upper income groups. Such a policy orientation is quite problematic and paradoxical in that the housing problem in Turkey is most dramatically felt by the lower middle and low income groups. Given this situation, recent policy proposals including the housing finance system are not a part of a social policy framework of the current government as oppose to the claims of the policy circles which introduce these changes.

Regarding the methodology of this thesis, first of all a literature review is made in order to establish the conceptual framework for housing finance in general and housing loans in particular. Secondly, beside housing data and demographic indicators, the statistical data of housing loans extended in the whole banking sector are evaluated.

For this study, randomly selected 100 housing loans files extended in Ankara by different branches of three commercial banks have been examined in terms of borrowers' profiles, housing characteristics and features of the extended housing loans. Additionally, in-depth interviews have been conducted with bank employees (a department manager and two directors) specialised in housing loans from three different commercial banks, with a specialist from Capital Market Board (SPK[9]) working in housing finance project team that prepared the draft law and with a department manager from Department of Strategy Developing in TOKİ who represented TOKİ in the meetings related to the draft law. In these

[9] Sermaye Piyasası Kurulu

interviews, the framework questions regarding the housing loans extended by commercial banks, current problems in lending process, the draft law, anticipated impacts of this regulation to housing finance and potential risks for lenders and borrowers were asked to the interviewees.

Following the introduction, chapter 2 provides the conceptual framework of housing finance and housing loans. In this chapter housing problem in the context of housing finance and housing finance systems are defined in both developed countries and developing countries. Beside the basic concepts in housing finance, primary and secondary markets for housing loans and the external factors which affect the housing finance and housing loans are also tried to be explained.

Chapter 3 reviews the housing finance system and mortgage loans in four countries with different levels of development. In this chapter, housing finance system and mortgage loans in the United States of America and the United Kingdom are analysed as the ‘successful models’ despite great differences in their housing finance systems. Brazilian and Colombian housing finance systems and mortgage loans are analysed basically for two reasons which are their similarity to our country in respect of macro economic conditions and similarity of the processes in housing finance regulations in the last decade. Also, the housing finance systems of these four countries are tried to be examined in the diachronic context and primary mortgage institutions, basic features of mortgage loans and the establishment of secondary mortgage markets in these countries are tried to be examined in order to understand and evaluate the recent developments in Turkey in terms of housing finance draft law. Beside the strong and weak sides, the achievements and the failures of each country’s housing finance system and mortgage loans will be discussed in the conclusion part of this chapter.

In chapter 4 Turkish housing finance experiences are reviewed. Due to the lack of a special circuit in housing finance, it is tried to be explained in the context of certain institutions which provided finance for housing in Turkey. In this chapter, after a review of demographic and housing characteristics of our country, housing loans provided by social security organizations and their contributions to the housing finance in Turkey will be explained. The housing loans and other contributions to housing sector of Emlak Bank which can be regarded as a specialist housing finance institution will be discussed. After an evaluation of Housing Development Administration (TOKİ)'s contributions to housing finance, commercial banks which are recently the main housing loan lenders in housing finance and housing loans are explained in detail.

Chapter 5 consists of four sections. In the first section of this chapter, the profile of borrowers of housing loans extended by commercial banks is tried to be explored. In the second section, the lending attitudes of commercial banks and the problems they encounter while lending housing loans are discussed in terms of current legal framework and funding process of these loans. The third section is devoted to the discussions on the draft law within the context of primary and secondary markets for housing loans. The last section is the conclusion part of this chapter in which a general evaluation will be made. The examined housing loan files extended by commercial banks and in-depth interviews are widely referred to in the analysis and discussions in this chapter.

In chapter 6, after a general evaluation of conclusions derived from other countries' examples within the context of global housing finance trends, the role of housing loans provided by commercial banks in housing finance in Turkey is evaluated and conclusions are formed depending on the analysis of both housing loans and the draft law. Finally, policy proposals will be made in relation to housing finance system in Turkey.

CHAPTER 2

CONCEPTUAL FRAMEWORK FOR HOUSING FINANCE

2.1 Housing, Housing Problem and Housing Finance

Definition of housing as a “shelter” in which households live is a very simplistic way of describing it. It has other functions such as being a commodity, a consumer good, a security for future of individuals and households, an intermediary for reproduction of social relations, the space of labour reproduction and investment tool. In addition to these functions housing may be defined as an instrument for economic revitalization and creation of employment and social and cultural artefact in terms of urban environment. (Tekeli, 1995)

Whether housing has been described simply as a shelter, then, it would be possible to define housing problem as ‘whether the adequate standard housing produced is distributed to every stratum of society, or not’ (Tekeli, 1996) However, multi functionality of housing not only leads to different definitions of housing problems but also complicates the definition of ‘solutions’. Besides, solution of a period itself may lead to further housing problems in another period.

Housing problem differs according to the development level of the countries due to the conditions affecting housing such as macro economic conditions, urbanization level, population growth, poverty etc.

The housing problem was considered as a quantity problem in most European countries due to the destructive results of the world wars on the existing house stock in the beginning of the last century. Beside the wars, urbanization in these countries and overcrowding in the dwellings also shaped the housing policies of these countries. Accordingly, after World War II housing policies generally aimed to increase the housing stock in numbers via mass housing construction (Ball et al., 1988). Almost all developed countries increased their housing stock as a part of their welfare policies especially in Europe.

Affordability of housing for a high proportion of households in most developed countries may not be regarded as a housing problem since 'well-organized' housing finance system exists which provides funds for the households to purchase houses (Abrams, 1966).

In case of developing countries, housing problem has been generally discussed in the context of rapid urbanization and poverty (Renaud, 1999). As a result of these factors "there is a massive housing problem in respect of the number let alone their quality" and this was tried to be solved by illegal housing by the people themselves (Boleat, 1985)

Affordability is another issue as a part of housing problem in developing countries. It will be misleading to argue that lack of housing finance systems leads to affordability problem. The main problem is lack of resources to be devoted in housing. In developing countries the allocation of limited resources to housing is very disputable. It is argued that allocating resources to housing instead of industrial development which creates added value means wasting the resources. Conversely, it is argued that house building is a locomotive industry which may promote the economy as whole (Keleş, 1990; Akçay, 2003)

Boleat (1985) argues that the purpose of a housing finance system is to provide the funds that buyers need to purchase their houses and the basic requirement of any housing finance system is the ability of channelling funds from people who have surplus of financial assets to those who wish to borrow.

Housing as an expensive consumption item the funds needed to purchase a house exceeds the current and expected incomes of the households for many years. So, a housing finance system should provide long term lending. Long term lending is an important feature of a housing finance system because

> as the size of funds needed to purchase a house is very high in relation to the income of the borrower, trying to repay the borrowed funds in a short term creates intolerable burden on their budgets. (Boleat, 1985)

The interaction between housing and housing finance is very explicit. Tenure structure in a country is basically related with the housing finance system. (Boleat, 1985) Lack of housing for rent, for instance, may lead to owner occupation as a major tenure type in a country with a developed housing finance system or squatter settlements in countries like Turkey which do not have 'adequate' -or at least any- housing finance system.

As the housing problems and definition of the problems differ in countries with different development levels, housing finance in developing countries is a very different subject from housing finance in developed countries. In the developed countries housing finance is discussed or studied in terms of how it operates under the implicit assumption that people can afford to buy houses and that there are financial institutions which will help them do so. On the other hand, in the developing countries the main argued issue is 'what is the convenient housing finance system?' and to what extent the existing housing finance system succeeds. (Boleat, 1985)

Nevertheless, an efficient housing finance system is expected to reduce housing problems and contribute to the overall economic development of a country.

2.2. Housing Finance Systems

Housing finance systems differ from country to country. However, in the literature there are two main classifications of these systems made by Mark Boleat in his book *National Housing Finance Systems* in terms of fund resources and Bertrand Renaud in his article *The Financing of Social Housing in Integrating Financial Markets: A View from Developing Countries* in terms of global trends in housing finance.

2.2.1. Housing Finance Systems in Terms of Fund Resources

Boleat (1985) classifies housing finance systems in four groups that are; direct financing, contractual system, deposit taking system and mortgage banking system within the context of resources of the funds to be used in housing finance.

In direct financing those who need funds to purchase a house obtain funds directly from the individuals with surplus funds. The lender in direct funding is usually a relative especially the parents. Older people lending money to their children to enable them to purchase or construct houses is the common way of direct financing. The other way of direct financing is builder finance. Typically, builder sells the house without demanding the whole price before construction. The price may be paid by instalments during and after the construction.

The direct financing predominates the housing sector in less developed countries in which intermediation is not developed, sufficient funds can not be supplied. Moreover, it is used in more advanced economies only when normal institutions are prevented from operating effectively (Boleat, 1985). Nevertheless, as a general rule, the more developed an economy the greater the extent of financial intermediation rather than direct financing of borrower by the lender.

Contractual system is second type of housing finance system. In this system regular savings are made over a period of time with an interest rate at below the market level and in return "the investor becomes entitled to a loan, again at an interest rate below a market level." (Boleat, 1985) In other words, in order to obtain a housing loan, people should deposit their savings for a certain period below the market interest rate level. The system is based on the savings of people who are potential buyers but may not be able to purchase houses with their own accumulations.

However, the contractual system can not provide the whole amount of funds necessary for a house. The system therefore has to be used with another financial system together. It is possible to assert that contractual system is being used partly as a method of tax-efficient saving for housing rather than funding whole house purchase. (Boleat, 1985) This system is used especially in Germany, France and Austria.

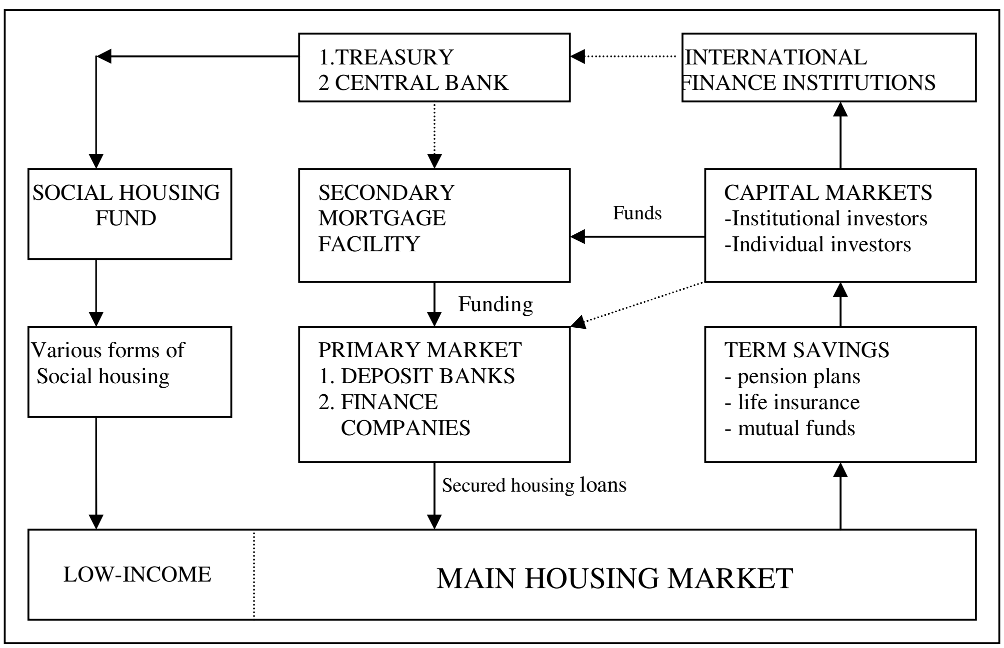
Deposit taking is third type housing finance system which is the most common one (Kim, 1997). According to this system, deposit taking institutions mainly commercial banks, savings banks and specialist housing finance institutions such as building societies in the United Kingdom or saving and loan associations in the United States of America use whole or a proportion of deposits for lending housing loans.

While some deposit taking institutions mainly use deposits for making housing loans, the others such as commercial banks make commercial loans for firms or consumer loans beside housing loans. This means that housing loans may be competing with loans for other purposes. (Boleat, 1985) These institutions may not prefer to lend loans for housing in case of inappropriate interest rate levels in order to avoid certain risks such as maturity risk which can be simply described as funding long term loans by short term deposits. Additionally, in developing countries beside maturity risk the funding of budget deficits increases interest rates for deposits and crowds deposit taking institutions out.

The last housing finance system is called mortgage bank system or mortgage bond system. In this system an institution make loans with the funds provided by issuing bonds covered by the mortgages. This system works effectively where an active and well-performing capital market exists. Bonds issued by mortgage banks are generally purchased by financial intermediaries such as insurance companies, pension funds, banks and individual investors (Boleat, 1985). This system is used very effectively in Denmark and Sweden.

2.2.2. Housing Finance Systems in Terms of Global Trends

Renaud's classification of housing finance system is based on six main categories which are made within the context of world trends in housing finance summarized in Figure 2.1.



Source: Renaud (1999)

Figure:2.1. World Trends in Housing Finance

According to Renaud (1999) the world trends in housing finance can be characterized by the features as the decline of special circuits for housing finance, the changes in the subsidy policies, the integration of housing finance to capital markets through the development of secondary mortgage market facilities, growing competition and innovation among banking institutions and mortgage finance companies and development of the various financial services such as appraisers, mortgage insurance services, improved property registration systems and etc. required for the development of mortgage markets both at the primary and at the secondary market levels.

Renaud classifies housing finance system in the world in six categories as undeveloped housing finance systems, missing housing finance systems in former centrally planned economies, fragmented and unstable housing finance systems, segregated but stable housing finance systems, sound and integrating housing finance systems and advanced housing finance systems.

Underdeveloped housing finance systems are found in countries where the per capita income is low, economic growth is volatile and informal finance is dominant, basic financial infrastructure does not developed and population density is low like the sub-Saharan Africa. According to Renaud (1999), the development of solid housing markets such as improvement of urban laws, policies and practices affecting housing and real estate should be given the priority.

Missing housing finance systems in former centrally planned economies such as former Soviet Union, Central and Eastern Europe, China and Vietnam may be characterized by the absence of commercial housing finance system because housing was regarded as a social issue to be met by the state in countries. The coordinated improvement of primary mortgage lenders and the development of secondary mortgage market facilities are needed in these systems (Jaffe and Renaud, 1996)

Fragmented and unstable housing finance systems are found in Latin countries especially during 1980s. The basic features of these systems are high inflation and macroeconomic instability and the dominant role of state in housing. According to Renaud, due to income inequalities and the inability of the majority of population to afford housing finance, state dominates the system with high subsidies which contributes to inflation. He argues that "the separation of subsidies from finance and the targeting of subsidies for social housing are essential ingredients of lasting reforms." (Renaud, 1999)

Segregated but stable housing finance systems can be found in some of East Asia and Middle East countries where strong economic planning policies are applied with relatively well managed macroeconomic policies. In these systems a limited number of institutions with some restrictions and special advantages coordinate the housing finance mainly targeting the quantity in housing with interest rates below the market. The contributions of formal financial intermediaries are limited. However Renaud (1999:770) criticizes these systems as

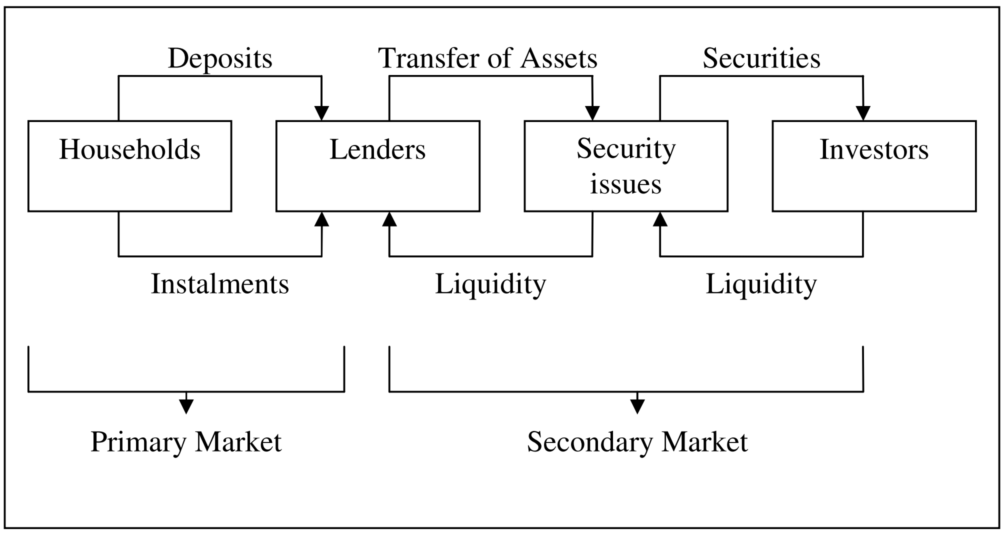
> The stability of this type of housing finance system should not be overemphasised because it is due to heavy regulation and poor competition and not to efficient risk allocation. Stability may well be more apparent than real. Poorly managed liberalisation and deregulation could reveal abruptly and in a costly way the underlying risks and efficiency problems that are presently hidden.

Sound and integrating housing finance systems are found in economies like Thailand and Malaysia "with outward growth strategies that are integrating well into world markets". According to Renaud, these countries provided the financial, legal, regulatory and supervisory frameworks for a successful housing finance system despite their low income levels such as liberated interest rates, competition in the primary market and developing secondary market.

Advanced housing finance systems can be found in developed economies such as the USA, the UK and the continental Europe. According to Renaud these systems grew out of two main traditions which are mortgage bank and special housing finance circuits lending mortgage by deposit taking.

2.3. Housing Finance Markets

Housing finance markets can be analysed in two categories which are primary markets and secondary markets for housing loans.



Source:Arrieta (2005)

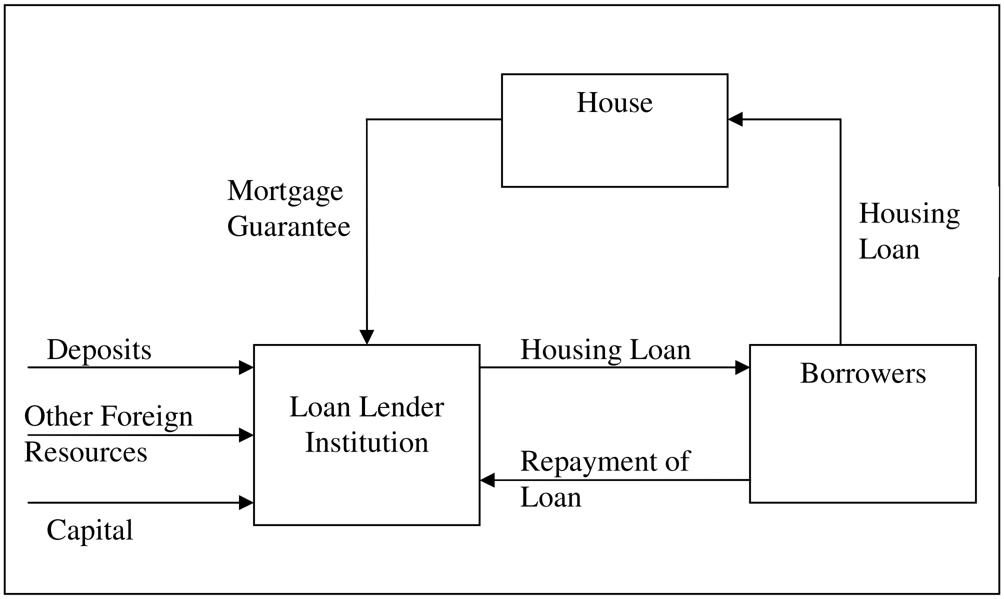
Figure 2.2. General Framework of Housing Finance Markets

As it can be seen from Figure 2.2., the secondary market is an issue related to the lender's side in which borrowers do not have any role in the operation of the market.

2.3.1 Primary Market for Housing Loans

Primary market is simply the market where lenders and borrowers come across and the funds are lent by financial institutions and borrowed by the consumers as housing loans. In other words, the loan relations set up between the lender and borrower and the transactions related to this loan are called as primary market

(Alp, 1996). The traditional lending activities are operated in this market. The Figure 2.3. below demonstrates the primary markets for housing loans.



Source: Kendir Tunalı (2004)

Figure 2.3 Primary Markets for Housing Loans

In the primary market financial institutions operating as lenders such as specialist housing finance institutions and commercial banks lend various types of housing loans which will be discussed in detail below.

2.3.1.1 Housing Finance Institutions

2.3.1.1.1. Specialist Housing Finance Institutions

Specialist housing finance institutions can be defined as bodies that devote almost all of their funds to lending mortgage loans. The resources of funds for the mortgage loans may vary in accordance with the type of fund providing activities of these institutions such as deposit taking, contractual saving or bond issuing but their activities are concentrated on mortgage loans which mean they become specialist in mortgage lending.

The most widespread type of these institutions are deposit taking institutions which collect deposits from savers mainly from households and lend these funds as mortgage loans in the primary market. The best examples of these institutions are savings and loan associations in the United States and building societies in the United Kingdom. These institutions do not finance business activities and lend commercial loans.

The other type of specialist institutions called contractual institutions of which the essence is based on regular savings made below the market interest rates over a period which will be extended as mortgage loans again with under the market rates to the investor. The Bausparkassen is a well-known example for these institutions (Boleat, 1985)

The last type of specialist institutions are mortgage banks that lend loans with funds obtained from bond issuing or selling the loan portfolio. These banks extend loans to house buyers and issue bonds covered by these loans in the capital markets in order to create funding. Mortgage banks operating in this way are widely found in Denmark. There are also mortgage banks in the United States that service loans and sell these loans to institutional investors. The basic differences among these mortgage banks are the ones in Denmark hold loans in their balance sheet while the others in the US do not hold them in their balance sheet (Kim, 1997).

However, starting with the 1980s these specialist institutions have had great transformations in terms of their functions. As they have lost their privileges both in funds' creating or borrowing and lending loans, their market share and importance have diminished. Most of them are converted to commercial banks (Diamond and Lea, 1992)

2.3.1.1.2.Commercial Banks

Commercial banks are the finance institutions providing a wide range of retail, wholesale and international banking activities. They may give service in different type of business. Their common feature is being deposit taking institutions. They lend loans for different purposes such as commercial credits or consumer credits beside housing loan.

In developed countries commercial banks dominate the housing finance system. On the contrary, commercial banks in the developing countries tend to have little role in housing finance simply because such business is inconvenient for them and they have other more profitable areas for their funds. Although in developing countries commercial banks seem to be natural point to initiate a housing finance system, lending long term housing loans are not profitable due to unsuitable macroeconomic and legal conditions such as inflation or restrictions on interest rates. (Jaffee and Renaud, 1996) Also there are some risks that commercial banks have to combat with that are credit risk, liquidity risk, interest rate risk and prepayment risk (Teker, 1996)

The first risk in lending housing loans by commercial banks is credit risk which is the risk of default on interest and instalments on the part of the borrower (Jaffee and Renaud, 1996). In other words, it is the risk that the borrower does not repay the loan in loan repayments.

Credit risk is measured by two ratios that are loan to value[10] (LTV) and payment to income. One of the precautions for credit risk is a well inquiry about borrowers. This is possible with a developed information system of customers of bank about their credibility. The other one is distribution of risk by diversifying the loans in terms of different criteria such as geography or occupation (Doğan, 2006)

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[10] Loan to value means the ratio of loan to the appraisal value of the house. The relationship between the amount of the mortgage loan and the appraised value of the property expressed as a percentage.

The second risk is maturity risk which means the mismatch of maturity of assets and liabilities of the lender. Funding long term housing loans with short term deposits causes liquidity risk. It is also called liquidity risk (Alp,1996).

The risk is measured by two main factors: first one is duration of loans and saving deposits; the longer the maturities of saving deposit, the lower the liquidity/maturity risk. Second the loan to savings ratio which means the larger the ratio, the greater the risk. Development of secondary mortgage market may be beneficial to reduce this risk through creating fund by selling the large loan portfolio or issuing bonds covered by mortgages or securitizing them.

Interest rate risk is the risk that banks may confront in case of changes in the interest rates. As Jaffee and Renaud (1996) states “the short term funding creates an interest rate risk for the lenders, since an increase in market interest rates raises the cost of deposits without immediately raising the return on the mortgage assets.”

The interest rate risk can be minimized by using adjustable interest rates[11] but it is only the displacement of interest rate risk to the borrower. Transferring interest rate risk to the borrower with adjustable interest rate may increase the credit risk. In other words the borrower may have difficulties in the prepayment due to high interest rates or may prepay the outstanding of loan amount in order to refinance it with lower interest rates which may lead to “ambiguity in cash flows” for the lender. (Jaffee and Renaud, 1996).

Prepayment risk is the risk of early repayment of the loan by the borrower typically in case of interest rate decreases. In other words the ambiguity of cash flows regarding with prepayment is called as prepayment risk. The other factor

[11] Adjustable interest rate is also known as floating interest rate or variable interest rate.

which increases this risk is refinancing of loan through another bank's loan (Alp, 1996; Jaffee and Renaud, 1996)

Adjustable interest rates generally decrease the risk of repayment. But the most common way of eliminating this risk to an extent is prepayment penalty applied.

2.3.1.2. Housing Loans/Mortgage Loans

Loan is a type of debt. The borrower initially receives an amount of money from the lender, which they pay back, usually but not always in regular instalments, to the lender. This service is generally provided at a cost, referred to as interest on the debt by the financial institutions such as banks.

A housing loan is also a kind of debt instrument used to purchase housing. The distinctive feature of these loans is that they are secured with a lien established on the purchased house. In other words, the bank is given the title to the house until the mortgage is paid off in full. If the borrower defaults on the loan, the bank can repossess the house and sell it, to get their money back. These loans generally have long maturities since the amount of the loan extended is great (Kendir Tunalı, 2004).

According to the housing policies and financial structure of the countries, different types of loans emerged in order to increase the demand for these loans while reducing the potential risks for lenders. They can be classified in three main groups in term of interest rates as fixed rate, adjustable and mixed mortgage loans.

2.3.1.2.1.Fixed Rate Mortgage Loans

Fixed rate loans are also knows as traditional mortgage loans of which the interest rate remains the same throughout the term of the loan for the borrower. The maturity of the loan may be up to 30 years. Repayment is done with monthly equal instalments (Uludağ, 1997).

There are also derivative loans with fixed rate such as graduated payment loans in which the repayment instalments are low at the beginning then increases as the income is expected to increase. This type of mortgage is suitable especially for young households (Alp, 1996).

Another important derivative loan type is interest only loans in which for a set term the borrower pays only the interest on the principle balance; the principle balance will remain unchanged. At the end of the interest only term, the borrower may either payoff the principle balance, or converts the loan to a principal and interest payment loan (Kendir Tunalı, 2004).

Fixed rate loans are mostly common in countries where inflation and interest rates are not volatile. It may cause interest rate risk for the lenders in countries with high and volatile inflation which means borrower can prepay the total amount in case of interest rate decreases but the lender can not change the interest rates in the reverse situation (Alp, 1996; United Nations, 2005).

2.3.1.2.2.Adjustable Rate Mortgage Loans

In these types of loans, the interest rate is adjusted periodically based on a pre-selected index. It is also known as variable rate mortgage loan. The interest adjustment may be done every month, 3 -6 months or every year depending on the changes in the selected index. They are available with any maturity up to 30 years. The changes in the loan amount based on interest rates may be shifted to the monthly repayments or the total loan amount with a maturity change (Alp, 1996).

The banks adjust the interest rates according to its cost of funds at the time of fixing the interest rate for the next period.

Derivative loans with variable interest rates are price level adjusted loans in which the interest rate is indexed to the inflation and dual-indexed loans in which the principal is indexed to inflation and repayments are indexed to increases in the wage of the borrower in order to cope with the risks caused by the inflation (Kendir Tunalı, 2004).

2.3.1.2.3.Hybrid Mortgage Loans

Hybrid mortgage loans are the loans in which the interest rates may convert to fixed type from adjustable or vice versa. For instance, there are loans in which the interest rate is fixed for certain term depending on the agreement of the borrower and lender usually for 5, 7 or 10 years and at the end of this term, it is converted to the adjusted rate loans. Likewise, convertible mortgage loan is another loan version in which the variable rates are converted to fixed rates in the period between 2 and 7 year of the loan (Teker, 1996).

As it is stated before, different financial conditions of the borrowers, the purpose to increase the demand for loans and elimination of certain risks cause the emergence of different type of mortgages.

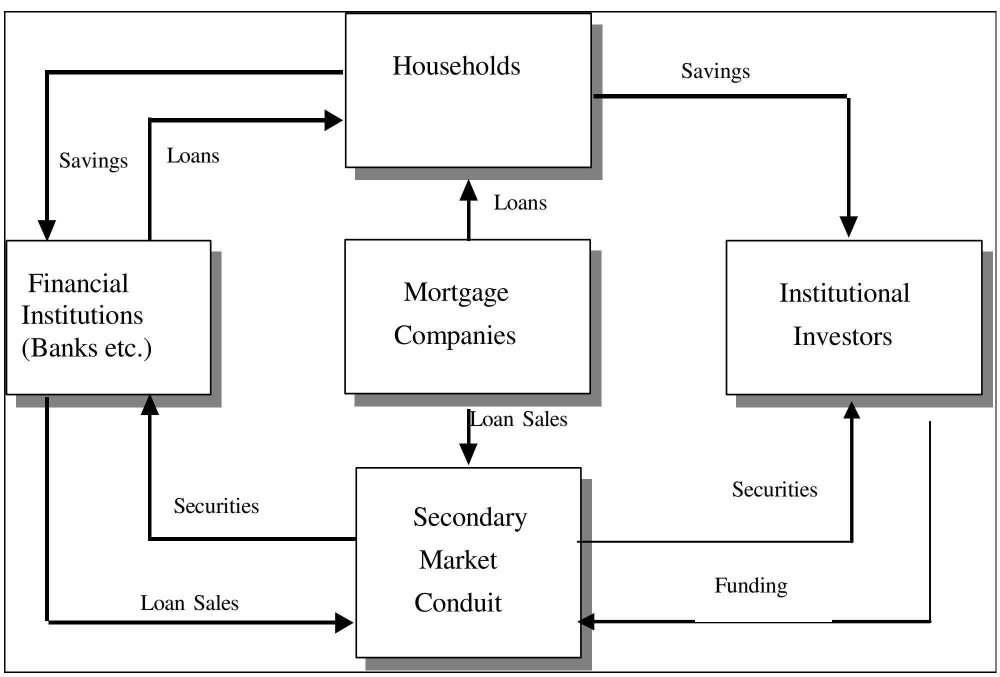
2.3.2. Secondary Market for Housing Loans

Secondary market is the market where lender creates funds either issuing bonds covered by these loans or by selling the loans to another institution in order to be securitized (Teker, 1996).

Firstly, loan lenders can issue bonds of which the collaterals are mortgage loans, in order to be sold to investors in the capital markets to create funds. These bonds are called mortgage covered bonds and they are on-balance sheet funding instruments. (Alp, 1996) That is to say; lenders carry the liability of these bonds and loans in their balance sheet. The loans which constitute the assets of the lender can not be used for any other purposes until the mortgage covered bonds are redeemed (Capital Market Board, 2004)

Secondly lenders can sell their loan portfolio to another institution to be securitized as mortgage backed securities. Mortgage backed securities are off-balance sheet funding instruments. That is to say, the lender transfers all liabilities and receivables related to the loans to another institution. In other words, it involves the transfer of the risks and ownership of mortgage loans to a third party (Uludağ, 1997).

Mortgage backed securities, the securities whose cash flows are backed by the principal and interest payments of pooled housing loans, are suitable to be traded in the market and may be issued in terms and with coupons (Alp, 1996). In the following Figure 2.4 illustrates simply how the secondary market operates



Source: Lea and Chiquer

Figure:2.4. Operation of Secondary Market with a Conduit

Although, providing liquidity from capital markets through mortgage covered bonds is a widely used way for mortgage loans in some European countries such as Denmark since the last century, the current secondary mortgage market with their instruments such as mortgage backed securities was developed in the United States in the 1970s as a method of selling mortgage loans in order to reduce the interest rate and maturity risks associated with fixed-rate mortgage lending (Lea and Chiquer,?)

2.4. The External Factors Affecting Housing Finance and Housing Loans

Housing finance system and housing loans are affected from many external factors related to macro economic and financial environments as well as legal and institutional regulations of the governments.

The macro economic stability is the *causa sine qua non* of an effective housing finance system (Kim, 1997). However, before discussing the effects of macro economic indicators such as inflation, interest rates, income level and employment on housing finance, it is thought that the impacts of free movement of capital on developing countries' economic stability should be discussed.

The housing finance system simply depends on the transfer of funds from savers to borrowers who are in need of funds to purchase a house (Boleat, 1985). Thus the basic requirement for this system is the existence of funds, in other words, accumulated capital known as savings. Whether the level of savings in an economy is high, the supplied funds for housing finance increase. However, in developing countries, the savings are not sufficient (Okpala et al, 2006). That is to say, insufficient capital accumulation in developing countries negatively affects the housing finance in particular and whole economy in general. With 1980s, the capital due to the globalization with the help of technological progress freely moves around the world. The developing countries enable the inflows and outflows of foreign capital in order to attract these funds for the sustainable economic growth and integrate to the global financial system (UN-Habitat, 2005). However, while the foreign direct investment contributes to economic growth in developing countries, the flowing capital called "hot money" which means indirect foreign investment threatens the stability in these countries due to sudden inflows and outflows[12]. Thus, it is obvious that capital inflows and outflows are one of the most important components that affect the macro economic and financial stability in a country especially the developing ones which have integrated to the global financial markets.

When we look at the macro economic indicators, inflation is the important determining factor in housing finance systems which affects the whole system (Kim, 1997). Almost all countries, but especially the developing countries have had serious inflation problems since 1970s. As it is stated above, housing finance system depends on fund transfer from savers to borrowers. As the inflation increases the uncertainty for the future yields, neither the savers as fund providers nor the financial institutions as the lenders prefer long term investment tools such as long term saving deposits or housing loans (Okpala, 1994). That is to say, inflation negatively affects both the demand side and supply side of housing finance (IDEA, 2004). As the value of repayments of housing loans diminish in high inflation rates, the lenders are reluctant to extent long term housing loans especially in fixed rates. While indexation of loan interest rates to inflation can protect the lender to some extent, the credit risk for these loans increase since the wages are not generally indexed to inflation and the ability of the borrower to pay the loan decreases especially in inflationary periods with great fluctuation margins. In other words, the loan repayments stays stable in inflation-indexed loans but the wages are eroded by the inflation. Moreover, interest rate which is "a price of capital to the borrower and a return on capital to the saver or lender" (Okpala, 1994:1581) is also dependent to inflation which means in a high inflationary environment, the interest rates are also high in order to cope with the diminishing effects of inflation. Since "like any other price, interest rates play

[12] See Corbo and Schmidt-Hebbel (2001) for details.

substantial roles in equating or matching the supply of and the demand for loanable funds" (Okpala, 1994:1581).

Income level is another factor that basically affects the demand for housing loans (TOKİ, 1993). The income level in developing countries are low compared to developed ones and most of the potential house buyers do not earn enough income to qualify for housing loans. In Latin America, for instance, nearly half of the population "live with per capita earnings of less than two dollars a day while 10 percent of the population earns 50 percent of the region's total annual income" (IDEA, 2004:2) which also indicates the unequal income distribution beside the low level income.

The other factor which affects the demand side of housing loans is issues related employment (Demir et al, 2003). As the unemployment level in an economy is low, the potential house buyers' ability to engage with housing finance market increase. Also, the lack of job security and existence of informal employment determine the ability to access the housing loans (Hardt, 2000).

The legal and institutional regulations of governments are also the external factors that have direct or indirect impacts on housing finance and housing loans. The housing policies applied, the taxation policies on housing and housing finance, the legal framework for ownership, foreclosure of mortgages, issues related to title, consumer protection are the regulations that affect the housing finance and demand and supply of housing loans (Kim, 1997; Mayo, 1999).

CHAPTER 3

HOUSING FINANCE SYSTEMS IN DIFFERENT COUNTRIES

3.1. Introduction

In this chapter, the housing finance system and mortgage loans in four countries, namely The United States of America, The United Kingdom, Brazil and Colombia will be reviewed within the context of housing finance institutions, housing finance loans and secondary mortgage markets in order to understand and make comparisons between these housing finance systems, determine the strong and weak sides of these systems, figure out the impacts of global trends in housing finance, and finally draw on these experiences in the policy proposals for our country. These four countries are analysed in this thesis for two reasons; firstly because mortgage loans are financed through deposits similar to our country, and secondly, despite significant differences in their housing finance systems and mortgage loans, they are regarded as 'successful models' having significant historical backgrounds under different socio-economic and financial conditions.

The housing finance experiences of these countries with different levels of development are discussed under two sections as developed and developing countries due to their common socio-economic and financial conditions deeply affecting their housing finance systems.

In the first section, The United States of America and United Kingdom's housing finance systems will be discussed in the context of primary mortgage institutions which means mortgage loan lenders, basic features of mortgage loans and the establishment of secondary mortgage markets. In the second section, Brazilian and Colombian housing finance systems and mortgage loans are reviewed. The experience of these two countries are very important basically for two reasons which are their similarity to our country in respect of macro economic and financial conditions and similarity of the processes in mortgage loans and housing finance regulations in the last decade.

In the conclusion part of this chapter, a comparative analysis of these four countries' housing finance systems and mortgage loans within the context of global trends in housing finance will be made in order to learn from their experiences "so that the same mistakes are not repeated and the best practice can be built on" in our country. (Boleat, 2003:3)

3.2. Developed Countries

Housing finance with mortgage loans in developed countries goes back to nineteenth centuries. Most of the institutions that still lend mortgage loans, for instance, building societies in the United Kingdom and savings and loans associations in the United States, were established in those years. Indeed, the institutional structure and market significance of the specialized mortgage lending institutions were established during the inter-war period in parallel with the development of mass market in house building in most countries that almost completed the urbanization period. (Ball et al., 1988)

However, during 1980s housing finance systems of developed countries began to change due to the inflation, interest rate volatility and deregulation. Specialized housing finance circuits began to decline, the role of commercial banks in mortgage loan lending increased compared to specialised housing finance institutions and housing finance became more integrated to capital markets especially with the development of secondary mortgage markets and free movement of capital in addition to enormous technological progress.

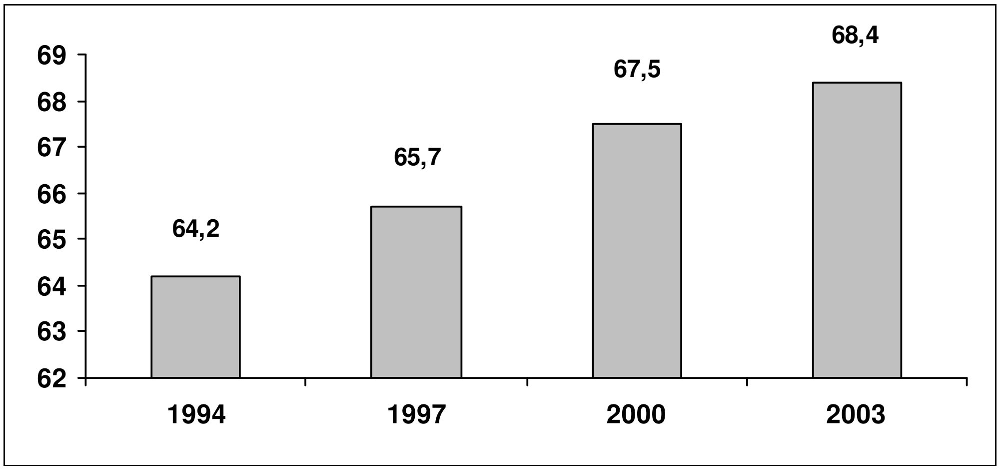
In the following sections the United States of America's and the United Kingdom's housing finance experiences were tried to be described in the context of primary mortgage markets, secondary mortgage markets and mortgage loans.

3.2.1 The United States of America

The United States of America with a population of nearly 290 million constitutes the 5 percent of world population. Approximately, 30 percent of population is under the age of 25. The total number of households is about 108 million with an average of 2.57 persons per household which was 2.62 one decade ago. The number of households has grown nearly 1 percent over the last five years

The total number of housing units in 2004 was 122 million. 87 percent of these were occupied full time and 13 percent unoccupied for various reasons (waiting for sale or holiday house).

Over the last ten years, an average of 1.5 million houses were constructed each year, with higher levels in the last three years due to greater housing demand stimulated by low interest rates. The average annual rate of growth of construction is 2.8 percent that is higher than the growth in households and may lead oversupply problems in the future.



Source: http://www.housingfinance.org/pdfstorage/USA.pdf

Figure 3.1. House Ownership Ratio in the USA (%)

As it can be seen in Figure 3.1., house ownership rate is increasing and close to 69 percent which was 63 percent in 1965.

The United States of America has a tradition of house ownership which is mostly referred to as an important part of 'American dream'. (Boleat, 1985). House ownership has been historically and ideologically supported by the governments in the USA and as a result, housing has become the largest asset of most American households which has great effects on wealth distribution. (Green and Malpezzi, 2000)

In the USA, housing has been considered as a 'commodity' unlike the European countries where the housing was regarded as 'public good' or 'social right' as a result of welfare policies. Because of this understanding, social housing, for instance, is so limited that only 2 percent of population has the opportunity to access social housing. Moreover, social housing expenditures have been highly criticized during 1980s, -the age of revival of 'liberal economy' all over the world.

The USA governments have never involved in the housing market directly. Instead ‘a regulatory role’ for the free market mechanism was adopted by the governments in case of market failures. The policies applied after the Great Depression in 1929 is the best example of its regulatory role especially in housing issues which will be discussed in detail.

In the USA mass house ownership developed as a result of “emergence of mass markets for owner occupied house building” in the inter-war period (Ball et al., 1988). Despite the crisis in the Great Depression period, the housing market recovered itself by the government’s regulatory policies and especially after the World War II, not only the supply of housing increased but also the physical conditions and quality of houses developed.

In the USA, compared to other developed countries, housing market has more linkages to financial system, has greater tax advantages and has less restrictive planning and regulatory environment especially for single family houses. (Green and Malpazzi: 2000)

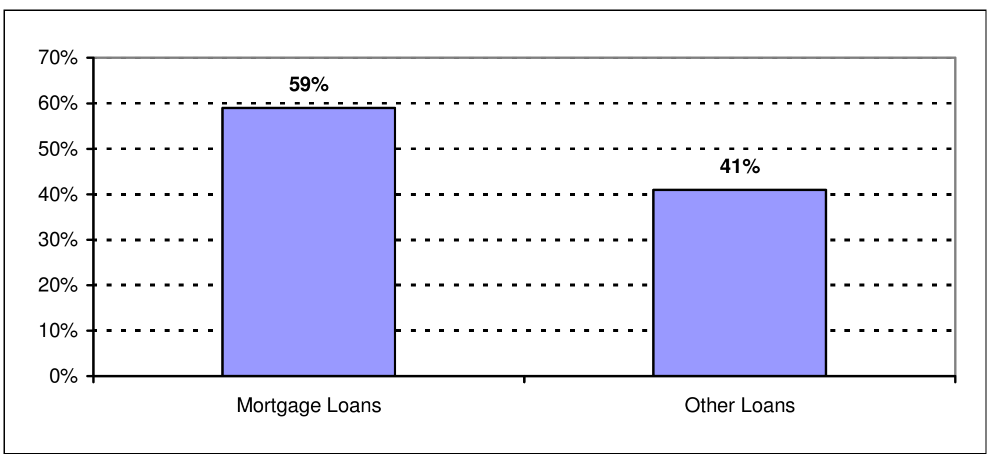
The United States as a model country for other countries has a comprehensive housing finance system which provides long term mortgage loans for home buyers. The system may be analysed in three sections which are primary market institutions, regulatory institutions for the primary market, and secondary mortgage market institutions.

3.2.1.1. Primary Mortgage Market Institutions

In the USA, the mortgage loan lenders can be mainly grouped into two as depository institutions that make loans based on deposits collected and non depository institutions that make loans based on funds from the sale of mortgage loans to investors or secondary market institutions.

Savings and Loans Associations, Mutual Savings Banks and Credit Unions are three main specialist mortgage loan lenders known as "Thrifts" or "Non-bank Depository Financial Institutions" They collect deposits and make mortgage loans based on these deposits[13] (Uludağ, 1997). Until 1980s the Thrifts were subject to constraints in the percentage of assets required to be held as mortgages and had same tax advantages in order to remain as specialist mortgage loan lenders which were eliminated by 1980s (Diamond and Lea, 1992). Commercial banks are the other depository institutions[14] that make mortgage loan in the housing finance sector beside other banking activities.

Mortgage institutions such as mortgage banks and mortgage brokers are non depository institutions which do not collect deposits but service mortgage loans. They give loans and sell them either to investor or to secondary market institutions after the insurance or government guarantee (Boleat,1985). In other words, these institutions provide funds for mortgage loans by selling their mortgage portfolios. There are also other non depository mortgage loan lenders such as insurance companies and pension funds in the USA.



Source: FED (in Kendir Tunalı, 2004)

Figure 3.2. Mortgage Loans Ratio in Total Loans in the USA (2003)

[13] Federal Savings and Loan Insurance Corporation (FSLIC) was established to insure the deposits held with thrifts.

[14] Commercial Bank deposits has been insured by Federal Deposit Insurance.

Table 3.1. Mortgage Loans in the USA (Billion USD)

Mortgage Loan Lenders	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
Thrifts	847,9	899,3	940,4	1052,8	1270,2	1398,3
Commercial Banks	1660,1	1789,8	2058,3	2255,8	2595,3	2956,6
Mortgage Institutions	32,1	32,1	32,1	32,1	32,1	32,1
Others	271,5	275,7	283,4	293,6	305,2	318,7

Source:FED

3.2.1.2. Regulatory Institutions for Primary Mortgage Market

After the 1930s economic crisis, the price of real estate had fallen sharply and both the households who borrowed mortgage loans and mortgage loan lenders had experienced financial difficulties. The government's attitude towards housing finance had changed in order to reduce the effects of economic crisis and to stimulate the mortgage market. As a consequence, institutions that would contribute the operation of primary mortgage market were established which are explained below in chronological order.

In 1932, Federal Home Loan Bank System (FHLBS) was established to regulate and provide liquidity for thrifts which have been the most important providers of mortgage loans. The system consists of 12 regional Federal Home Loan Banks (FHLB) working as the central banks for savings and loan industry (Mortens,1988) The duties of FHLBs are to regulate and audit their member thrifts. They give credits with the maturities of 1 month to 10 years to Thrifts. The Thrifts are also shareholders of FHLB and they can be credited for the amounts 12 times of these shares by FHLB. Additionally FHLB can use the deposits of member institutions as a source of fund for mortgage lenders in different states. Members can use credits from the US treasury (Ball et al., 1988).

In 1934, Federal Housing Administration (FHA) was established to insure the mortgage loans in case of payment defaults of borrowers in order to minimize the credit risk of the lenders especially in high loan-to-value ratios. The other objectives of this institution were to increase investor's confidence in mortgage assets and to encourage the adoption of the long term, self amortizing mortgage instrument (Diamond and Lea, 1992). While insuring these loans FHA had made contributions to housing finance market such as setting physical housing standards.

Additionally, Veterans Administration (VA) was established beside FHA to insure mortgage loans with some standards, to facilitate and encourage house ownership and make the loans attractive like FHA. Moreover, VA has another function that is to finance directly Second World War veterans. Some advantages had been provided for veterans such as lack of down payment and insurance premium (Uludağ, 1997).

There are also private insurance companies that insure the mortgage loans. But the insurance premiums taken by both FHA and VA are less than the private ones.

With the establishment of these institutions, the necessary conditions for the operation of primary mortgage market have been constituted such as additional resources for lenders, insurance of mortgage loans, standards for these loans etc.

3.2.1.3.Secondary Mortgage Market Institutions

The housing finance system in the US relies heavily on the secondary market. The secondary market, where securities backed by mortgage loans are bought and sold, is dominated by the Government Sponsored Enterprises (GSEs) which are Federal National Mortgage Association (Fannie Mae), Government National Mortgage Association (Ginnie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac).

In 1938 Federal National Mortgage Association (Fannie Mae) was founded to increase liquidity and to pull private capital to mortgage market by operating in the secondary market as a buyer and seller of the insured mortgage loans and securitizing them. In order to function properly in the secondary market Fannie Mae was authorised to get credit from US treasury. Besides increasing the liquidity in the market, supporting the growth of non-depository lenders was another function of Fannie Mae (Cummings and DiPasquale, 1997).

In 1968, with National Housing Act, this association was separated into two institutions namely Federal Home Loan Mortgage Corporation (Fannie Mae) and Government National Mortgage Association (Ginnie Mae).

After this separation, Fannie Mae has become a private institution purchasing only the loans insured by FHA or VA and to a limit conventional mortgage loans with an aim of developing secondary market for mortgage loans. This institution issues bonds backed by mortgages or securitize mortgage loans as mortgage backed securities.

Government National Mortgage Association (Ginnie Mae) is a state owned institution with a task of supporting mortgage market by purchasing mortgage loans insured by FHA and VA under the state guarantee. It was an agency of the federal government providing credit guarantee and facilitating direct sale in the capital markets (Diamond and Lea, 1992). In 1970s 'full guaranteed pass through mortgage backed securities' program has started. These securities are the most reliable securities since the mortgage loans backed these securities are insured by FHA and VA. Ginnie Mae provides the funding to perform its functions from the treasury credits and repayments of mortgage loans. Ginnie Mae also insures the private creditors' mortgage backed securities.

Federal Home Loan Mortgage Corporation (Freddie Mac) was established as a half-state institution in 1970 to purchase mortgage loans insured by FHA and VA in order to increase the liquidity. With the establishment of Freddie Mac, the number of institutions operating in the secondary market has increased to three. Freddie Mac like Fannie Mae benefits from borrowing privilege from US Treasury (Diamond and Lea, 1992). Securities issued by these institutions have the guarantee of themselves, there is no federal government guarantee on these securities (Cummings and DiPasquale, 1997)

The combined mortgage portfolios of the GSEs in 2003 were $1.5 trillion. The mortgage loans securitised and held on the balance sheet by GSEs was $3.6 trillion which constitutes about 47 percent of the total residential mortgage debt outstanding at the end of 2003 (http://www.housingfinance.org)

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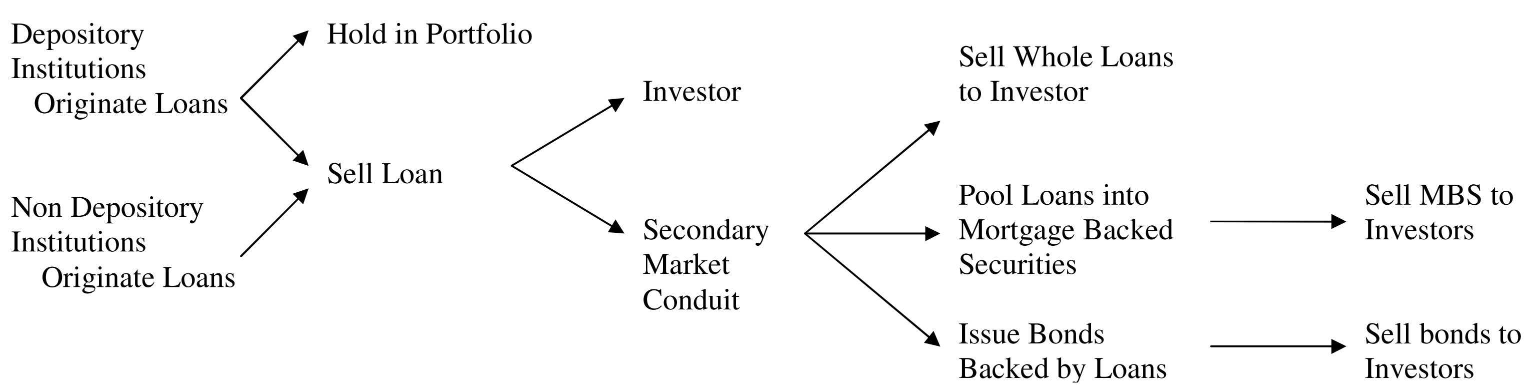
MORTGAGE MARKET ACTORS

Mortgage Originators
Depository Institutions
-Commercial Banks
-Thrifts
 -Saving & Loan Associations
 -Saving Banks
 -Credit Unions
Non Depository Institutions
-Mortgage Banks and Mortgage Brokers
-Insurance Companies and Pension Funds

Secondary Market Conduits
Government Sponsored Enterprises
-Fannie Mae
-Freddie Mac
-Ginnie Mae
Private Investment Banks

Investors
-Pension Funds
-Life Insurance Companies
-Commercial Banks
-Thrifts
-Fannie Mae

MORTGAGE MARKET PROCESS



Source: Cummings and DiPasquale (1997)[additions were made on the original figure]

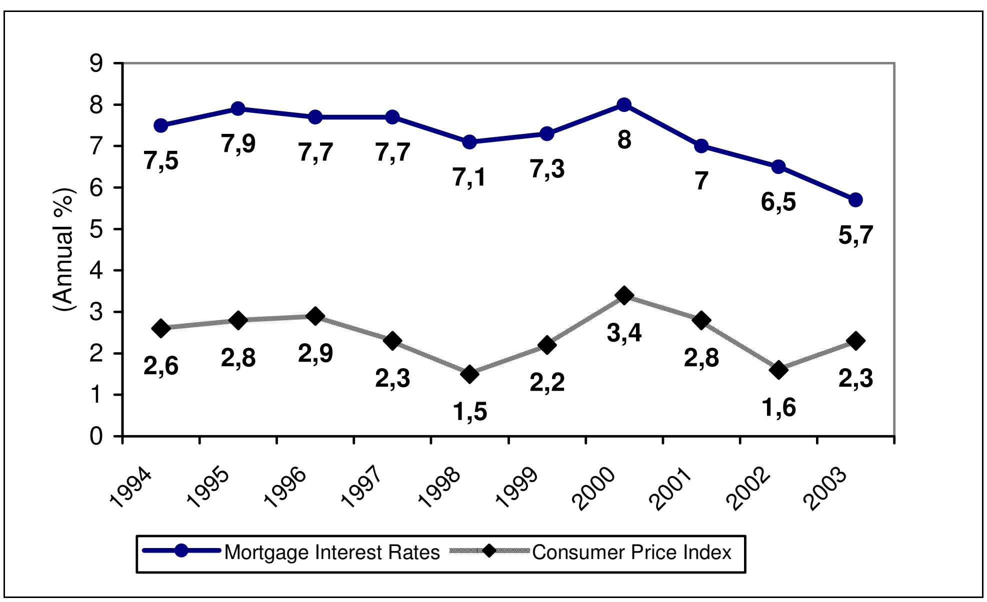
Figure 3.3. Diagram of Mortgage Market in USA

3.2.1.4. The Basic Features of Mortgage Loans in USA

In the United States the mortgage loans have long term maturity changing between 5 to 30 years with fixed nominal interest rates. There are also mortgage loans with variable/adjustable interest rates. However they are not as popular and demanded as the mortgage loans with fixed interest rates. The market share of fixed interest rate mortgage is 82 percent. (Scanlon and Whitehead, 2004)

Although the fixed rate mortgage loans dominate the housing finance market, they carry interest rate risk for the lender which means changes in the interest rates can not be reflected to the borrower. Indeed, it is mostly argued that the main reason behind the development of secondary markets and integration of housing finance and capital market is the existence of this risk which caused problems for lenders in the USA (Diamond and Lea, 1992).

The interest rates of the loans have been moving parallel to the inflation rates as it can be seen from the Figure 3.4.



Source: http://www.housingfinance.org/pdfstorage/USA.pdf

Figure 3.4. Consumer Price Index and Mortgage Interest Rates in the USA

Although the maximum loan to value ratio is 90 percent, the average is 73 percent for mortgage loans. 62,2 percent of owner occupiers purchased their houses with mortgages. (Scanlon and Whitehead, 2004)

In the USA there is not penalty for prepayment which encourages the borrowers to refinance onto lower interest rates. A significant proportion of the increase in lending in recent years has been refinancing which accounted for about two thirds of single-family mortgage originations in 2003.

Housing receives favourable tax treatment in the US. There is no tax on capital gains after a two-year holding period. In addition, owner-occupiers are permitted to deduct mortgage interest payments and property taxes from their incomes subject to tax. Owner-occupiers can deduct both for their first and second homes. The upper limit is $1.000.000 of principal on which the interest payment is deductible (Green and Malpezzi, 2000).

Total outstanding residential mortgage debt in the USA at the end of 2003 was $7.8 trillion. This accounts for 69 percent of US GDP. Per capita mortgage debt is approximately $27,000 and by household $74,000 which means that most American households live indebted for a long period during their life-span. (http://www.housingfinance.org-/pdfstorage/USA.pdf)

Table 3.2. Summary Data for the USA

	1994	1997	2000	2003
Real GDP growth (%)	2.9	4.5	3.7	3.0
Unemployment rate (%)	6.6	4.9	4.0	6.0
Residential debt/GDP Ratio	49	51	56	69
Residential mortgage debt per household ($)	36,904	42,798	54,298	73,566
Number of Households, millions	977	1,010	1,043	1,077
Annual House Price Growth (%)	1.8	3.5	6.9	7.0
Typical LTV (%)	79.9	79.4	77.8	73.5
Refinance Share (%)	28	29	21	66

Source: http://www.housingfinance.org/pdfstorage/USA.pdf

3.2.2. The United Kingdom

The United Kingdom has a population of 58,9 million. The population growth from 1980 to 2001 was only 6 percent in total (Ball, 2005). The total number of dwellings was estimated at 25.3 million in 2004, with the average household size steady at 2.4 people.

In the United Kingdom, until late 1960s housing was considered as a problem of quantity since the number of households was exceeding the housing stock. Additionally, 75 percent of the existing housing stock was in poor conditions and overcrowded. But in the 1970s the number of houses became more than the number of households (Balchin, 1996).

In the United Kingdom, the housing was highly affected from the policies of two political parties, Conservative Party as a supporter of owner occupation and Labour Party as supporter of public housing. (Boleat, 1985). But when tenure types are analyzed, it can be asserted that housing has been mainly regarded as a 'public good' and 'social right' to be provided by the state with the public expenditures on housing through local governments as a consequence of being a welfare state irrespective of which party was in power until the beginning of 1980s.

Table 3.3. Tenure in Great Britain (%)

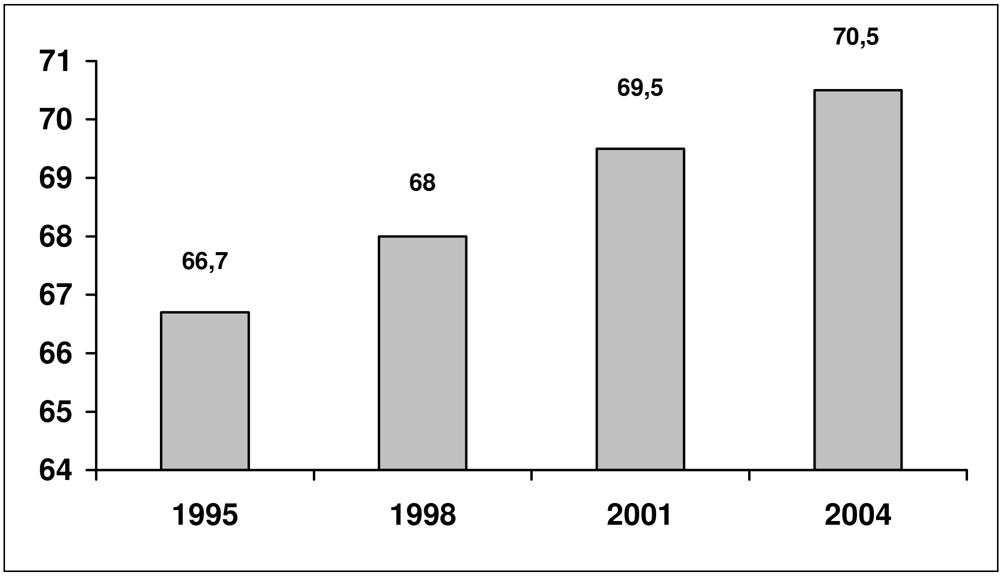
Years	Owner-occupied	Housing Associations	Local Authority	Private-rented
1950	29.0	-	18.0	53.0
1961	42.3	-	25.8	31.9
1971	50.6	-	30.6	18.9
1981	56.6	2.2	30.3	10.9
1991	66	3.2	21.2	9.6
2001	69,5	7.0	14.5	10.0

Source: Department of Environment (Balchin, 1996) and RICS (Ball, 2005)

However, Conservative Party came to power at the end of 1979 and the introduced new economic program aiming the liberalization of the economy affected housing deeply. Because tight macroeconomic policies led to decreases in total public expenditure on housing as a result of "reducing the rate of inflation, applying policies of privatization and cutbacks in public expenditure". (Balchin, 1996). He argues that:

> Conservative policies have aimed specifically to increase the proportion of the housing stock under owner occupation and to reduce the attractiveness of local authority housing. At the same time, there was an attempt to resurrect private renting and to expand the housing-association sector-as if to compensate for the decline in local authority housing (Balchin, 1996:227)

One of the most important policies applied by conservative government was the 'Right to Buy" legislation which gave most local authority tenants the right to buy their dwellings at substantial discounts. (Ball, 1983). According to this legislation, local authority housing was privatized either by selling them to tenants or transferring them to housing associations, trusts and private companies for renting or resale. It was not surprising that as a consequence of policies applied by Thatcher government owner occupation was overwhelmingly became the largest tenure as it was aimed to "dismantle the public rented housing and promote private ownership and management" (Balchin, 1996)



Source:http://www.housingfinance.org/pdfstorage/2811151205.pdf

Figure 3.5. House Ownership Ratio in the UK (%)

Not only housing but also housing finance was also deeply affected from the policies of conservative government. In the following housing finance of the UK will be analysed in the context of primary mortgage market, secondary mortgage market and basic features of mortgage loans.

3.2.2.1.Primary Mortgage Market

Until 1980s building societies were the dominant mortgage loan lenders which benefited from privileges provided by the state. However, with the deregulation, other financial institutions such as commercial banks also entered the housing finance market as mortgage loan lenders

Building societies are mutually owned institutions operating on deposit taking principle since late 1800s. (Boleat, 1985; Diamond and Lea, 1992). They were taking deposits in order to make mortgage loans and were not allowed to invest in financial markets to create funding for these loans until 1980s. During 1970s they were "protected from competition in savings and lending market" since the commercial banks were not allowed to lend mortgage loans. Commercial banks were “focussed on businesses rather than individuals” (Diamond and Lea, 1992).

The restriction of banks by credit controls called “the corset” provided the opportunity for building societies to be leaders in both taking deposits and lending mortgage loans. In other words, building societies took the advantage of restriction for commercial banks to expand their activities to mortgage market, “uncompetitive terms and conditions offered to savings, favourable taxation and low priced funds for savers” (Whitehead, 1994).

Building societies both accept the savings and lend loans at variable interest rates which provide advantages coping with fluctuations in interest rates and lending long term mortgage loans based on short term deposits. Furthermore, it is generally not limited to which extent interest rates can be varied. (Boleat, 1985)

Interest rates up to 1980s were irrespective of the economic conditions as a result of being “partly shielded from macroeconomic fluctuations” which permit the application of “below-market administrated rates” (Diamond and Lea, 1992) Building societies were setting the interest rates that would be applied to both deposits and mortgage loans based on the advice of building societies association.

In 1980, the credit controls over commercial banks were eliminated and they began to compete for mortgage loans lending and savings with building societies. According to Diamond and Lea (1992) this competition led to building societies’ “rate-setting cartel” to be abolished by 1984. Since 1984 changes in mortgage rates were linked to changes in the interest rates in the financial markets.

Table 3.4. Shares of Mortgage Loan Lenders in the UK (%)

Years	Building Societies	Commercial Banks	Other
1980	80	8	12
1990	81	13	6
2001	20	71	9

Source: Diamond and Lea, 1992 and Ball 2005

As it can be seen from the table the share of commercial banks in mortgage loans enormously increased. The main reason of such a great increase is discussed as the transformation of building societies into commercial banks. (Ball, 2005)

3.2.2.2. Secondary Mortgage Market

Secondary mortgage market activities in the United Kingdom have begun with the first transaction of mortgage backed securities issued in January 1985. In the beginning USA based institutions dominated the secondary mortgage market who also set the standards of market (Pryke and Freeman, 1994). Although companies called "centralized lenders" namely National Home Loans Corporation, The Mortgage Corporation and Household Mortgage Corporation were established in order to operate in the secondary mortgage market, the securitization is generally made by the institutions that originate the mortgage loans.

The "centralized lenders" which were lending mortgage loans funded from the securitization of loans contributed to the development of secondary market in 1980s. The secondary market grew very rapidly in late 1980s which led to a housing market boom. The share of these companies in mortgage loan market reached to almost 15 percent. However, their share declined to 5 percent in early 1990s as a consequence of decline in housing market. (Diamond and Lea, 1992; Karley and Whitehead, 2002).

During 1990s, the secondary mortgage market was dominated by these companies who raised funds from securitization. Primary mortgage lenders i.e. building societies and commercial banks entered the securitization market in the late 1990s in order to create new sources of financing. (Karley and Whitehead, 2002)

Building societies may securitize 40 percent of their mortgage loan portfolio. In general, 70 percent of the loans is financed through the deposits and the 30 percent is financed by the funds raised by the securitization of loans as mortgage backed securities.

The amount of issued mortgage backed securities has reached to £40 billion in 2004 which was under £2 billion in 1997. The total outstanding mortgage backed securities was about £90 billion at the end of 2004, "accounting for almost 12 percent of all outstanding residential loans (http://www.housingfinance.org).

Although the secondary mortgage market of the United Kingdom is a growing market, its volume is still low compared to the existing mortgage loan outstanding. It is argued by Green and Watcher (2005) that securitization is low in United Kingdom because the variable rate mortgage loans dominate the market. Since the lenders have not carried the certain risks such as interest rate risk which have been absorbed by the borrower due to the variable interest rates, they have not been very enthusiastic for the securitization of their loan portfolio. Furthermore, it is argued that tax rules favouring government debt precluded the formation of mortgage bond market (Diamond and Lea, 1992)

3.2.2.3. Basic Features of Mortgage Loans in the UK

In the United Kingdom, the basic source of mortgage lending has been deposits and the interest rates applied to both deposits and loans have been variable rates which enable the lenders to cope with both maturity and interest rate risks due to borrowing short term and lending long term.

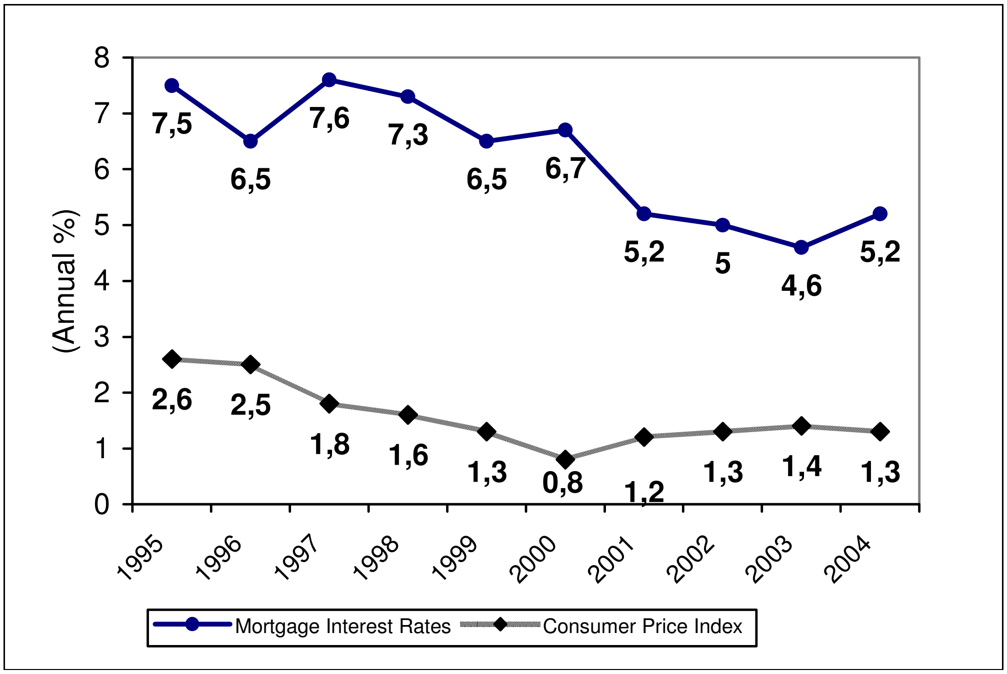
The most important consequence of variable rates is the changes in mortgage repayments because of the changes in interest rates. It is argued that this uncertainty does not cause problems because the "borrowers act and budget accordingly" as they know interest rates may change and "take account of this when deciding the loan amount" (Boleat, 1985) When the interest rates increase the option of lengthening the maturity of the loan may be chosen by the borrower instead of increasing the monthly repayments.

On the other hand, the reason why fixed-rate mortgages have never been widely used in the UK is explained as the borrowing habits are "path-dependent" which means "borrowers do not understand the benefit of paying a higher coupon rate in exchange for a reduction in balance sheet risk." (Green and Wachter, 2005)

Moreover, another advantage of variable interest rate is argued by Boleat (1985) as:

> Arguably the variable rate mortgage has also helped preserve stability in the housing market. When rates have risen sharply, borrowers have not been deterred from purchasing as they would be if interest rates were fixed, because they have had the knowledge that when interest rates generally come down than their rates will also fall.

In the United Kingdom although mortgage loans are mainly in variable rates, there is also an alternative of mixed rate loans in which the rates are fixed for a period of 1-10 years, than changes to variable rate. However, traditional fixed rate mortgages like in USA do not exist in this country.



Source:http://www.housingfinance.org/pdfstorage/2811151205.pdf

Figure 3.6. Consumer Price Index and Mortgage Interest Rates in the UK

On the other hand, as it can be seen in Figure 3.6. the interest rates are relatively high compared to low inflation.

In the United Kingdom, there is not prepayment penalty like in the USA and the maturity dates extends up to 25 years. Maximum loan to value ratio is 110 percent but the market practice is about 70 percent. Also, the tax relief which was used as an instrument to promote ownership in 1980s was abolished. (CGFS, 2006).

There are also flexible mortgages which permit over-and-underpayments, payment 'holidays' and offset mortgages where loan and deposits are in linked accounts, and deposits are offset against the loan balance.

In United Kingdom mortgage market has grown very rapidly in the last decade as a result of excess demand for housing. As it can be seen in the Table 3.5., the residential debt/GDP ratio reached to 78,9 percent and mortgage debt for each household was nearly doubled in 2004. The value of outstanding residential mortgage debt has grown to £875 billion at the end of 2004, from £390 billion in 1995, an average increase of 9.4 percent per year. The reasons behind such an increase are low mortgage interest rates together with sustained economic growth and high employment. (http://www.housingfinance.org)

In 2004, there were approximately 150 lenders in the UK mortgage market, but the market is relatively concentrated with 57 percent of the market held by the five largest institutions.

Table 3.5. Summary Data for the UK

	1995	**1998**	**2001**	**2004**
Real GDP growth (%)	2,8	3,0	2,2	3,2
Unemployment rate (%)	8,3	6,1	5,2	4,7
Residential debt/GDP Ratio	45,5	48,7	57,4	78,9
Residential mortgage debt per household (£)	16.031	18.321	23.172	33.730
Annual House Price Growth (%)	0,7	11,0	8,4	11,8
Typical LTV (%)	84,4	83,7	81,0	73,6
Refinance Share (%)	28,5	25,6	31,3	41,6

Source: http://www.housingfinance.org/pdfstorage/2811151205.pdf

Despite the excess demand, supply of housing did not increase which led to rise in the price of houses as it can be seen in Table 3.5. The growth of house price over the last ten years has been above the general rate of inflation. Since the increase in incomes of households has been naturally below the house price growth, affordability problems have occurred in the United Kingdom.

Refinancing of mortgage loans has been steadily increasing over the last decade which accounted for almost 42 percent of lending in 2004, compared to 28.5 percent in 1995.

3.3. Developing Countries

In developing countries, housing finance systems have been shaped under two common features beside external factors such as rapid urbanization, high population growth and unstable macro economic conditions. First of all, since the private capital accumulation i.e. savings have been insufficient for financing housing through mortgage loans and public funds in the forms of mandatory deposits or subsidies have played crucial role in housing finance. Secondly, state owned specialised housing finance institutions were established in order to channel necessary funding to housing finance and lend mortgage loans, since the long term mortgage loans were not profitable for private finance institutions in an economic environment with high inflation and interest rates. However, mortgage loans lent by these institutions were limited due to the lack of both private and public funds compared to developed countries.

Beginning with 1980s, most of the developing countries have to deal with very high inflation rates which deeply affected housing finance and mortgage loans. Specialised housing finance institutions which were blamed to play the crucial role in the failure of housing finance systems have lost their importance or abolished or transformed in their functions. However, it can be argued that the specialised housing finance institutions could not function efficiently due to lack of continuous flowing funds in most of the developing countries in an inflationary environment. Moreover, the governments have tried to cover the budget deficits especially with the funds devoted to housing finance.

The global trends in housing finance also affected developing countries in terms of lending housing loans. Decline of the existing special housing finance circuits in these countries caused housing finance to be left to the market conditions which also negatively affected the availability of housing loans. Additionally in most countries housing finance was tried to be integrated to capital markets in order to provide funding from these markets and eliminate the risks of loan lenders such as maturity risk or interest rate risk with secondary market facilities. However, it seems difficult to claim that they succeeded in providing funds from capital markets due to some reasons which will be discussed in the conclusion part of this chapter.

In the following section, housing finance experiences of Brazil and Colombia are tried to be explained in the context of development of housing finance systems and emergence of secondary markets.

3.3.1.Brazil

Brazil has a population above 180 million and 82 percent of the population lives in urban areas. It is estimated that there exists nearly 7 million dwelling unit deficit in the country and the deficit is increasing 3 percent every year despite the construction of 1,1 million dwelling unit.

In Brazil, like other developing countries, direct financing constitutes the largest portion (73 percent) of housing finance. A considerable amount of population lives in illegal dwelling which were financed with family lending or personal savings. Beside these, there is another way of direct financing which is very common in Brazil. In order to raise capital for their project the real estate developers and builders offer their financial scheme that is known as instalment sale. Rocha (2000:6) explains this way of housing finance

> Normally they start selling flats or offices well before the construction is started. Construction begins when the flow of instalment is sufficient to pay for part of the building costs. By the time the purchaser receives the keys to his home or office normally after 48 months, most of the costs have already been paid for. The purchaser, however, continues paying instalments for another 12 to 52 months, pending on the project.

In Brazil, beside direct financing people have the opportunity to finance their houses through housing finance system although the system has been highly criticized for being eligible only for upper-middle and upper income groups. In the following mortgage loans in Brazil will be discussed in the context of development of housing finance system and emergence of secondary mortgage market.

3.3.1.1. Development of Housing Finance System and Mortgage Loans

The formal housing finance system goes back to 1960s in Brazil. Although inflation has been an acute problem since 1950s, the introduction of indexation as a consequence of monetary correction and adjustment in order to remove the negative effects of inflation both in savings and loans, made long term housing loans available. In 1964 beside indexation, National Housing Bank (BNH) was established as a first step of housing finance system and it began to function with 27 savings and loans institutions as the tools of deposit taking and lending activities (Uludağ, 1997).

The system had seemed to operate well until 1980s. However, acute economic problems, such as inflation and budget deficits caused a partial collapse of the system in 1980s. Mandatory deposits made by employers were not transferred to savings and loans institutions for housing finance. Instead, these funds were used to cover budget deficits especially between 1984-1988 periods. Since the lending institutions could only make loans based on deposits with high interest rates, housing loans rapidly diminished. In addition to diminishing funds for housing finance, it is discussed that the length of foreclosure process also forced the banks to be very selective in their lending activities in that period.

In 1990s due to the collapse of the housing finance system BNH was abolished and the functions were transferred to Federal Savings Bank (*Caixa Economica Federal* -CEF). (Uludağ, 1997)

Brazilian housing finance system "relies on two basic funding resources: saving deposits held by the people with financial institutions authorized by the Central Bank of Brazil and mandatory deposits made by employers in accounts held in the names of their employees in the Fundo de Garantia do Tempo de Servico or FGTS[15]" (Debutsky and Posch, 1998) According to FGTS, 8 percent of gross income of employees working both in the public and private sector has to be deposited. It is claimed by Uludağ (1997) that what made the system work "successfully" has been the cheap funds from these mandatory deposits.

In 1994 Plano Real has begun to be implemented in Brazil. Plano Real was an economic stabilization plan adopted in order to reduce budget deficit, lower the rate of inflation and introduce a new stable currency the Real, the value of which is linked to the US dollar. The stability generated by the plan led to an increase in the demand for housing and long term funding (Rocha, 2000).

Recently, housing loans are lent by financial institutions authorized by the Banco Central do Brazil to raise savings deposits. There are 41 such institutions, including the CEF and one savings and loan association. The remaining financial institutions are private or state-owned multi-chartered banks. (Rocha, 2000)

Interest rates applied to housing loans have been reviewable rates in Brazil. Monthly repayments of mortgage loans are recomputed in accordance with the index called UPC have been calculated according to whole price index. In 1980s, the banks revaluated the deposits according to UPC index per annum while the loans were revaluated in every 3 months. However, revaluation of savings and loans in different terms led to problems such as higher increases in debts for the borrowers and repayment of instalment. Since the incomes did not increase as much as mortgage debts, repayment difficulties occurred (Uludağ, 1997).

[15] Workers' Compensation Fund administered by the Federal Savings Bank

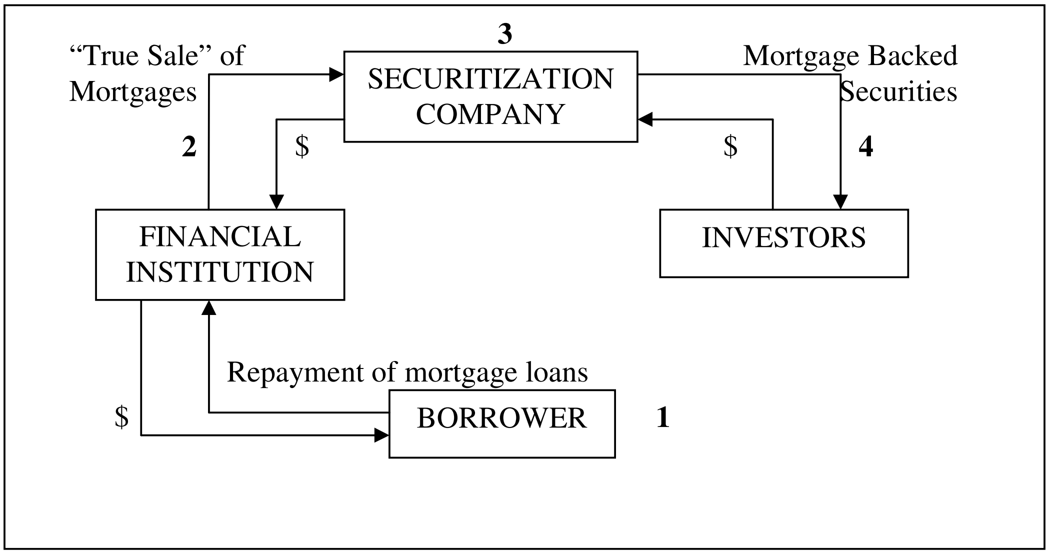
In Brazil, housing loans are grouped into two those made under Housing Finance System (HFS) and those made under market conditions. Loans made under HFS; which are adjusted monthly according to the index applied to savings deposits, have maximum 90 percent loan to value ratio (market practice is 50-60 percent) and have maximum term of 20 years (market practice 10-12 years). In this system the collateral of the loan is the mortgage of the house being financed. Loans made under market conditions are negotiated between lender and the borrower with interest rates normally above HFS loans and are also subject to monthly monetary adjustment. Housing loan lenders should lend 60 percent of the deposits as housing loans of which 80 percent must be HFS loans (Rocha, 2000)

3.3.1.2.Emergence of The Secondary Mortgage Market in Brazil

In 1997, a comprehensive legal framework for Brazilian mortgage loans market has been established with passage of Law 9514. In accordance with this law CIBRASEC has been established as a securitization institution in order to create funding for housing loans through the secondary markets.

CIBRASEC's shareholders consist of private sector (70 percent) including the major financial institutions as well as foreign banks, and public sector (30 percent) namely Federal Savings Bank (CEF) with a share of 10 percent and government of Brasilia/DF with a share of 20 percent (Debutsky and Posch, 1998).

The main aim of this institution has been to achieve the regulation of secondary markets like Fannie Mae and Freddie Mac in USA. It has been designed to purchase real estate credits and receivables from lenders such as mortgage companies, banks, real estate credit companies, savings banks and savings and loan associations and to issue securities guaranteed by such credits and receivables. In other words, the main functions of this company are creation of a standardized mortgage-backed securities and developing standardized servicing guidelines for secondary mortgage markets. As it is stated by Debutsky and Posch (1998) “this securitization company is a limited purpose entity designed to facilitate the securitization of mortgage loans by isolating them from the balance sheet of their originator and by issuing securities backed by the cash flow of the mortgages”



Source: Debutsky and Posch (1998)

Figure 3.7. Securitization Process in Brazil

According to the securitization process in Figure 3.7., the borrower who took up a mortgage loan makes mortgage loan instalment and insurance payments to the mortgage loan lender. Mortgage loan lender sells the mortgage loans to a securitization company and has the advantage of removing these loans from its balance sheet. The securitization company which buys the mortgage loans issues securities which are mortgage backed. Payments from the loans are used to support repayment of these securities. These mortgage backed securities are sold to the domestic or foreign investors.

The securities issued by CIBRASEC called *Certificados de Recebiveis Imobiliarios* (CRI) are expected to raise funds in the capital markets to be used for new mortgage loans purchases. These securities are also expected to satisfy the need for medium or long term investments in Brazil of which the main buyers are the institutional investors such as pension funds, insurance companies and foreign investors. (Rocha, 2000; Debutsky and Posch, 1998)

In Brazil, with the law 9514, the foreclosure law was also changed for the 'efficiency in the operation of mortgage loans market'. It is asserted that with this law, the legal framework for the ability to seize and liquidate the property upon a debtor default in a 'timely manner' has been constituted. The property is held in the name of the trustee and procedures to recover the credit are out of court. The foreclosure period has been reduced to 6-12 months. (Debutsky and Posch, 1998) It is argued by Debutsky and Posch (1998) that this amendment has encouraged the financial institutions to increase their mortgage loans.

As a conclusion, although the integration of housing finance to capital markets in order to provide funds and eliminate risks of lenders immanent to long term housing loans is regarded as a must (Debutsky and Posch, 1998), three economic shocks, namely the Southeast Asia (1995), The Russian crisis (1997) and devaluation of Real in January 1999 have forced the Brazilian authorities to increase the domestic interest rates rapidly to prevent a major capital flight which caused delays in the development of secondary mortgage market in Brazil (Rocha, 2000).

3.3.2. Colombia

Colombia has a population of 44 million and there exists 15 percent housing deficit. Population increases in Colombia at an average of 1,8 percent annually while the urbanization rate is 2,6 percent on average in the last decade which means the housing deficit is increasing year by year (Clavijo et al., 2004; Gomez et al., 2005)

In Colombia, 70 percent of the population lives in cities. It is stated that "unlike other Latin American countries where, most of the urban population is concentrated in a single city, Colombia's is highly decentralized, as evidenced by the fact that four cities (Bogotá, Medellin, Cali, and Barranquilla) have more than 1 million inhabitants each and 38 cities have populations over 100,000" (Gomez et al., 2005). House ownership in this country is about 58 percent. (Clavijo et al., 2004)

3.3.2.1. Development of Housing Finance System and Mortgage Loans

Housing finance system in Colombia which started in 1920s faced with problems due to the increasing inflation in 1970s. In 1972, the indexation program *Unitad* Unit of Constant Purchasing Power (*De Poder Adquisitivo Costante* -UPAC) was introduced as a part of National Development Plan in which housing was considered as the leading sector in order to achieve the economic growth. Specialist institutions called Housing Savings and Loan banks (*Corporacion de Ahorra y Vivienda*- CAV) were created to provide long term housing finance. (Gomez et al., 2005)

Under this system, CAVs were privileged for using indexation mechanism called UPAC which meant both loans and savings were indexed to inflation by which both the lender and the depositor were protected against the losses due to inflation. By this indexation system, it was aimed to keep the mortgage loan repayments constant during the life of the mortgage loan. (Işık and Patel, 2004)

Furthermore, liquidity ratio and required reserve ratio[16] were applied to CAVs (5 percent) less than commercial banks (25 percent).(Uludağ:1997). There were also special credit lines through which the central bank *(Banco de la Republica*) could automatically provide cash to CAVs in case of large withdrawal of savings.(Gomez et al., 2005)

[16] Required reserves maintained at the Central Bank.

These institutions not only lent loans to the consumers but also to the building companies that produced houses. The basic characteristics of the mortgage loans were; the borrowers could take out loans without waiting for deposit accumulation period. The deposit accounts were applied real interest rates regulated by the state. The interest rates of mortgage loans were in reviewable rates and changed according to the maturity date and region. The rates were determined and regulated by the central bank. The maturity dates were between 10-20 years. The indexes determined by the central bank are used by CAVs. (Uludağ:1997)

CAVs were obliged to allocate 7 percent of their total funds (resources) to low income level groups for mortgage loans. Houses for low income level were financed totally with mortgage loans given by CAVs. The state did not undertake or subsidize these loans when repayment problem occurred. (Uludağ:1997)

Until 1990s CAVs grew enormously due to the privileges given to them. Over 10 million people were saving their deposits in CAVs and CAVs' share in banking portfolio was 35 percent. As they were specialised in housing finance, the mortgage loans as a percentage of GDP reached to 6 percent (Clavijo et al., 2005).

In Colombia, commercial banks were not allowed to lend mortgage loans and CAVs were not allowed to carry out the functions of the commercial banks. Besides commercial banks were not allowed to use indexation mechanism to the deposits. The deposits held with them were applied nominal interest rates which led to shift the deposits to CAVs (Uludağ,1997).

In 1990, new economic reforms were introduced and a new law number 45 was enacted in order to liberalize the financial activities and create competition between CAVs and banks. There were two important changes made by this law which were the change of indexation calculation and abolishment of privileges of CAVs. The indexation was adjusted to fixed term deposit interest rate not to the inflation. With the abolishment of privileges, on the one hand, CAVs had the opportunity to diversify their financial products, on the other hand, the cost of funding increased due to the competition for short term funds which also created maturity mismatch and difficulties for long term lending.

Nevertheless, during 1990s as a result of inflow of foreign capital to Colombia, both the housing sector and housing loans experienced booms and mortgage loans as a percentage of GDP reached to 11 percent in 1998 (Gomez et al, 2005)

However, the economic environment began to change due to the outflow of foreign capital at the end of 1998. The Central Bank increased the interest rates in order to stabilize the exchange rates. The interest rates were relatively high compared to inflation and this caused increases in outstanding debt of housing loan borrowers. Furthermore, government tried to finance budget deficit by the funds in the domestic market. As a result, economic crisis occurred in Colombia which led to increase in inflation and unemployment. The eradication of borrower's payment capacity beside the increase in the outstanding of housing loan increased default rates to 13 percent (Forero, 2004). The price of houses sharply decreased which were the collateral of the mortgage loans. In addition to these economic problems, the declaration UPAC system as unconstitutional by the Constitutional Court caused enormous damage in the housing finance system. (Forero, 2004; Gomez et al., 2005)

In 1999, a new Housing Law number 546 was passed which led to several important changes in the housing finance system. First of all, a new indexation system called *Unidad de Valor Real* (UVR) was started to be used in which the index calculation was again linked to the inflation. Secondly all CAVs were converted to commercial banks. Thirdly a new social housing policy called *vivienda de interes social* (VIS) was introduced in which banks were obliged to allocate a portion of mortgage loans for social housing. Fourthly, the mortgage loans were standardized in order to be securitized in the secondary mortgage market. Finally the institutions and instruments were created for the secondary market. (Gomez et al., 2005)

Recently, mortgage loans in Colombia may be lent for 5 to 30 years although the market practice is 10-15 years. The loan to value ratio is 80 percent for social housing and 70 percent for other houses. The maximum monthly instalment may not exceed 35 percent of the income. Although the interest rate of mortgage loans are adjusted according to the inflation, the Constitutional Court set ceiling for interest rates of housing loans which were 11 percent for social housing and 13,9 percent for other houses. (Forero, 2004; Gomez et al., 2005)

In Colombia, it is permitted to deduct the mortgage interest payment from the income subject to tax.

3.3.2.2. Emergence of Secondary Mortgage Market in Colombia

According to Law 546, non-credit institutions were allowed to be created to securitize housing loans. *Titularizadora Colombiana* (TC) was created in 2001 as a securitization company, main purpose of which was to increase the liquidity for long term housing loans from the capital markets.

Chiquier et al., (2004) argue that the creation of TC was a response to the crisis in mortgage market occurred in the late 1990s as a result of interest rate shocks, increasing unemployment and falling house prices in addition to "risky system of indexed credits".

As it was stated above, in Colombia the resources of housing loans are deposits and there is a maturity risk for long term housing loans funded by short term deposits. By the creation of TC, the origins of housing loans have begun to change from deposits to funds from capital markets provided by mortgage bonds and mortgage backed securities. (Forero, 2004)

TC has been used by mortgage lending institutions to securitize part of their mortgage portfolios for various maturities mostly 5,10, 15 years. Within its first two years the company issued four securities (TIP's) for 13 percent of the outstanding residential mortgage debt (Chiquier et al., 2004).

Although TC has not been providing guarantee to the securities, the interest of domestic bond market investors has been increasing. The loans and securities are UVR-indexed fixed real rate credits. Although the performance of both the securities and pool has been good, prepayment rates are high and market practice of loan to value ratios are low.

Since 2002, a fund controlled by a public agency called Fogafin has provided guarantee for the securities issued by banks or securitization companies backed by social housing loans (VIS Loans). Fogafin has charged premiums for the guarantee provided and with this guarantee the quality of securities is increased and they "enhanced to the level of public debt" and funding cost of VIS has been reduced. Fogafin has the opportunity of getting budgetary support when needed. (Chiquier et al., 2004)

The securitization companies are benefited from income tax exemption. Beside all investors of mortgage backed securities issued until 2006 have been utilized from certain tax exemptions. It is argued by Chiquier et al. (2004) that "this regressive subsidy artificially reduces the cost of funds through securitization."

Also, the banks have allowed to issue mortgage bonds which are "on balance sheet funding tool" by using mortgage pools as collateral with the housing finance law and subsequent regulations. (Chiquier et al., 2004)

Furthermore, in 2002 with amendments in Civil Proceedings Code and the Lease Act the foreclosure process has been decreased from 48 months to 18 months in Colombia. (Forero, 2004)

As a result, it is believed that Colombia has become a ‘well-performing’ country among developing one in the integration of housing finance to capital markets. Recently, 30 percent of the Colombian mortgage portfolio is securitized which amounting to 1,5 billion USD (Gomez et al., 2005).

3.4. Conclusion

Housing finance systems in different countries have totally different characteristics in accordance with their socio-political, macro economic and financial conditions like the four countries analysed in this chapter. Although, the common point of these housing finance systems is being subject to the enormous effects of global trends which are decline of special housing finance circuits, increasing share of commercial banks in mortgage loans compared to specialized housing finance institutions and the integration of housing finance to capital markets through secondary mortgage markets since the 1980s, it is difficult to state one of them as the most successful housing finance system, because they operate in different conditions and all systems have different features which make them stronger or weaker. In fact, the success of the system should be determined according to the capability of coping with the failures of the system.

The housing finance system in the United States of America in accordance with its tradition of house ownership is comprehensive and consistent and mainly supports the mortgage loan borrower with the policies such as fixed interest rates, lack of penalty for prepayment, tax relieves and insurances. The mortgage loans are extended with fixed interest rates generally, although the other alternatives are available such as adjustable interest rate mortgage loans, graduated payment mortgage loan, balloon payment mortgage loan etc. In fixed interest rate mortgage loans interest rate changes can not be reflected to the borrower, furthermore the prepayment is allowed and borrower has the opportunity to refinance its mortgage when the interest rate falls. Additionally the borrowers are permitted to deduct mortgage loan interest payment and property taxes from their incomes subject to tax. Finally, the mortgage loans are insured by public institutions such as FHA and VA beside private insurance companies which provides security for the both the lender and borrower.

In this system, there are some risks that lenders of mortgage loans carry such as maturity risk, interest rate risk and prepayment risk. The mortgage loans are basically financed by deposits in the USA and deposit maturity is very short compared to mortgage loans and this way of financing loans cause maturity risk for the lender institution in the balance sheet. Secondly, the upward changes in interest rate create risk for the lenders because while the cost of deposits is rising, it is not possible to raise the current extended mortgage loans. Thirdly, in the case of decrease in the interest rate, borrower can prepay the mortgage loan, which creates prepayment risk and necessity to rearrange assets and liabilities for the lender.

As a result, in USA housing finance has been integrated to capital markets to eliminate the risks immanent to the system which finance fixed rate loans with deposits for a long period beginning from 1930s. The secondary mortgage market in this country which is the most regulated one has been successful in eliminating these risks and in creating liquidity for the lenders that has led to the growth of mortgage loan market.

The housing finance system of the UK which relies on deposits, on the contrary heavily bears these risks to the borrower since the loans are dominantly extended with variable rates which means in case of interest rate changes the borrower carry the interest rate risk. However, this does not create a great disadvantage for the system mainly for three reasons that are borrower's ability to acting and budgeting accordingly, stability preserved by the lack of fluctuations in the demand for the mortgage loans, and thirdly the better macro economic conditions such as relatively stable and low inflation and interest rates which provide the system work efficiently.

Also, since these risks have been absorbed by the borrowers with the variable rate mortgage loans, and the savings are sufficient for loan lending, mortgage loan lenders have been reluctant for the securitization of their loan portfolio and as a result, the secondary mortgage market has not developed and the securitization is low in the UK.

Brazilian and Colombian housing finance systems have been operating in similar macro economic and financial conditions. First of all, these two countries have suffered from high inflation and interest rates and budget deficits. Secondly, capital accumulation i.e. savings is insufficient due to low income levels. Thirdly, they are vulnerable to external financial and economic effects of free movement of capital such as sudden capital inflows and outflows which may cause financial instabilities and crisis in these countries

In both countries, the housing finance system and long term mortgage loans have experienced radical transformations due to changes in their macro economic and financial conditions. Beside the decline of special housing finance circuits, the specialist housing loan lenders also transformed into banks and legal and institutional infrastructure has been provided for the secondary mortgage market in order to eliminate the risks immanent to mortgage lending with deposits and provide liquidity for housing loans.

In Brazil and Colombia mortgage loans are extended in reviewable interest rates which are indexed to inflation in order to cope with the depreciation of the value of mortgage loans for the lenders which also means that interest rate risk has been transferred to the borrower like in UK. However, during unstable and high inflationary periods which are common in developing countries, this indexation system lead to increases in the payment defaults of the borrowers since the outstanding of the mortgage loans increase more than the incomes do. It can also be argued that this high possibility of payment defaults in mortgage loans may be the reason for the exaggerated emphasis on foreclosure periods for the default mortgage loans in developing countries.

Although the interest rate risk for lenders is eliminated by reviewable rates, the other risks such as maturity risk in short term borrowing and long term lending are tried to be eliminated by secondary mortgage market facilities. However, it is obvious that the main aim of secondary mortgage market is to provide funds from capital markets and increase liquidity in these developing countries by attracting foreign capital since the domestic capital markets are shallow and capital accumulation is insufficient.

Although the legal and institutional infrastructure for the secondary mortgage market have been completed, it is hard to claim that both countries have succeeded to increase the liquidity in the primary markets and provide the expansion of loan market in spite of the fact that Colombia compared to Brazil, has achieved to develop a better-performing secondary mortgage market.

In conclusion, although the housing finance system of these countries seems 'functioning' in market conditions despite great structural changes, it will be useful to remind that the global economic developments such as decreasing inflation and interest rates, oversupply of money, growing economies in most of the countries, capital inflows to developing countries have created an optimist environment for financial issues. Whereas in case of economic stagnation, an increasing trend in interest rates, capital outflows[17] for instance, middle and long run results of structural changes in housing finance due to above mentioned global trends may be highly disappointing in fragile economies such as Brazil, Colombia and naturally our country.

[17] See Sheng and Kirinpanu (2000) for a dramatic example of housing finance and housing sector collapse in Thailand in 1997 as a result of foreign capital outflow.

CHAPTER 4

HOUSING FINANCE IN TURKEY

4.1. Introduction

In this chapter, Turkish housing finance experiences are reviewed. Housing finance policies in Turkey have been experienced in three periods which can be summarized as housing finance policies for civil servants, housing finance with subsidies as a result of welfare politics and neo-liberal housing finance policies. However, lack of a housing finance system limits our analysis to the institutions that have provided housing loans in Turkey. By this review, it is aimed to discuss formerly applied policies and current policies of the institutions that have provided housing loans in order not to repeat the same mistakes made by these institutions in the implementation of housing finance policies.

Firstly, to provide a framework for the review, demographic and housing characteristics of our country will be given. Secondly, housing loans provided by social security institutions namely by Social Security Organization (SSK[18]), Armed Forces Pension Fund (OYAK[19]) and Social Security Organization of Merchants and Artisans and Other Self-Employed Professionals (Bağ-Kur[20]) and their contributions to the housing finance in Turkey will be explained. Thirdly, housing loans and other contributions to housing sector of Emlak Bank as a specialist housing finance institution will be discussed. Finally, after an evaluation

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[18] Sosyal Sigortalar Kurumu

[19] Ordu Yardımlaşma Kurumu

[20] Esnaf ve Sanatkarlar ve Diğer Bağımsız Çalışanlar Sosyal Sigortalar Kurumu

of Housing Development Administration (TOKİ[21])'s contributions, commercial banks which are recently the main housing loan lenders in housing finance and housing loans are explained in detail. It is needless to say that the policies of these institutions related to housing finance and housing loans will be analysed within the context of macro economic conditions and legal framework they operated.

In the conclusion part of this chapter, a critical evaluation of these experiences will be made in the context of other countries housing finance experiences.

4.2. Demographic and Housing Characteristics of Turkey

The population of Turkey is almost 72 million with an annual growth rate of 1.3 percent. in 2005 (Turkish Statistical Institution, TÜİK[22]). The age distribution of the population is remarkable since nearly 40 percent of the population is under 20. This age distribution signals the enormous need for new housing in the forthcoming years, because the population projections until 2020 indicates that economically active population groups between 20-59 will grow as it indicated in the Figure 4.1.

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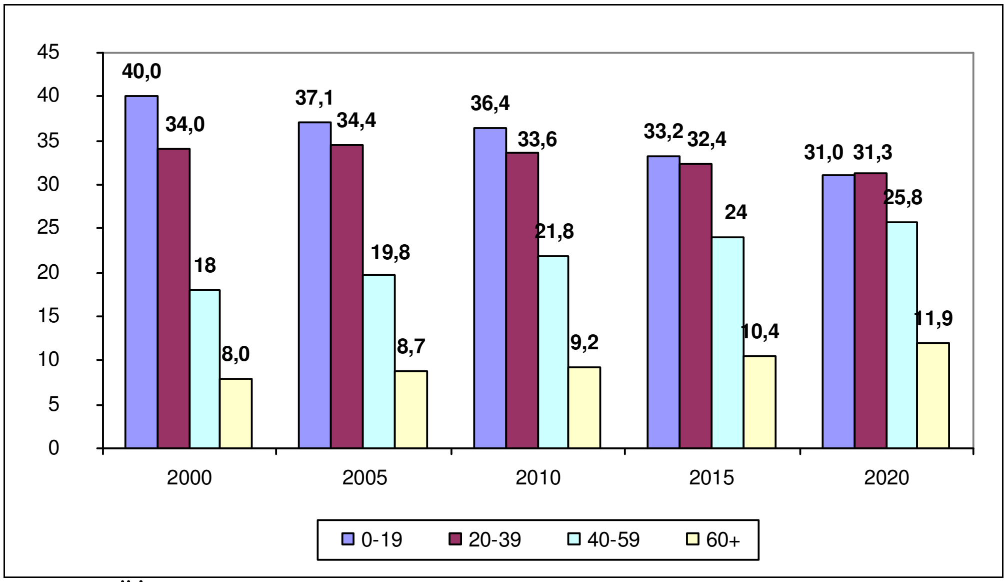
[21] T.C Başkanlık Toplu Konut İdaresi Başkanlığı

[22] Türkiye Istatistik Kurumu



Source:TÜİK

Figure 4.1. Population and Population Projections by Age Groups in Turkey (%)

Moreover, as it can be seen in the Table 4.1., households are overcrowded in Turkey (almost two fold of household size in the USA and the UK) and there is a downward trend in household size. According to Table 4.1 it can be stated that the increase in household numbers due to the trend of smaller household sizes will also increase the housing demand. This excessive potential demand for housing may lead to additional housing problems.

Table 4.1. Total Number and Average Size of Households in Turkey

Years	Total Number of Households	Average Size of Households
1955	5.237.176	5,68
1960	4.558.325	5,68
1965	5.536.116	5,67
1970	6.261.949	5,69
1975	6.982.505	5,78
1980	8.522.499	5,25
1985	9.730.018	5,21
1990	11.118.636	5,05
2000	15.070.093	4,50

Source:TÜİK

Table 4.2. Urban Population Growth in Turkey

Years	Total Population	Urban Population	% of Urban Population
1927	13.648.270	3.305.879	24,22
1935	16.158.018	3.802.642	23,53
1940	17.820.950	4.346.249	24,39
1945	18.790.174	4.687.102	24,94
1950	20.947.188	5.244.337	25,04
1955	24.064.763	6,927,343	28,79
1960	27.754.820	8,859,731	33,69
1965	31.391.421	10,805,817	34,42
1970	35.605.176	13,805,817	38,45
1975	40.347.719	16,869,068	41,81
1980	44.736.957	19,645,007	43,91
1985	50.664.458	26,865,757	53,03
1990	56.473.035	33,326,351	59,01
2000	67.803.927	44,006,274	64,90

Source:TÜİK

The urbanization which gained momentum with the 1950s, led to an increase in the population of big cities such as Istanbul in which 23 percent of the total population was settled, and 44 percent of the total urban population was settled in cities whose population is over one million at the end of 2000. It is stated by Karakaş and Özsan (2005a) that "adequate urban housing supply could never keep up with the demand" and earthquake risk in Turkey makes the problem worse.

According to the Table 4.3. below, the housing production has a downward trend from 1995 to 2002. Although, it declined significantly between 1999 and 2002, it started to increase in 2003. The main reasons for the decline in housing production were the Eastern Marmara Region earthquakes in 1999 and economic crisis in 2000 and 2001. After the earthquakes in 1999, the government temporarily stopped issuing construction and occupancy permits. Additionally, due to the economic crisis the purchasing power of nearly 80 percent of the population diminished significantly. (Karakaş and Özsan, 2005a)

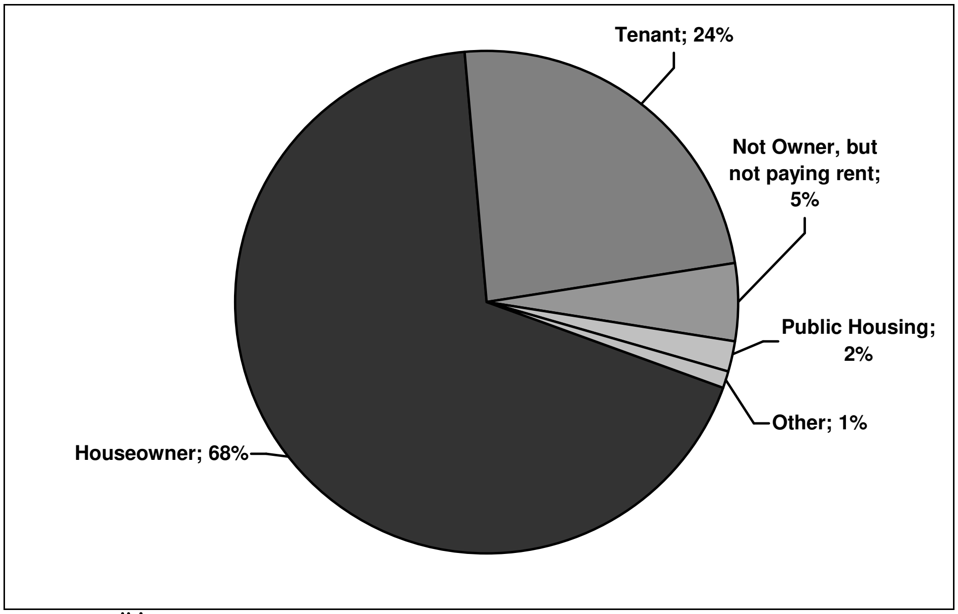
Table 4.3. Production of Residential Housing in Turkey (Number of Flats)

Years	Construction Permits	Occupancy Permits
1995	518,236	248,946
1996	454,295	267,306
1997	464,117	277,056
1998	414,573	219,737
1999	339,446	215,613
2000	315,162	245,155
2001	279,616	243,464
2002	161,920	161,491
2003	202,854	162,908
2004	330.446	164.994
2005	511.236	240.730

Source: DPT, TÜİK

The total number of housing units is estimated above 17 million which also includes summer houses, second houses and squatters. According to TOKİ, 40 percent of the urban housing stock needs renewal and 55 percent of housing stock in Turkey is unauthorized housing. It is estimated by State Planning Organization (DPT[23]) and TÜİK that there exists a housing shortage of nearly 2,5 million. The demographic and housing data stated above implies that the growing demand for adequate housing units at affordable prices will continue in the future. (Özsan and Karakaş, 2005a)

[23] Devlet Planlama Teştilatı



Source:TÜİK

Figure 4.2. Distribution of Housing Tenure in Turkey (2000)

According to the 2000 census data the house ownership is the largest type of tenure with 10.290.843 households. House ownership is followed by tenancy with a share of 24 percent. 5 percent of households is neither house owner, nor tenants. 2 percent of the households lives in public housing who is state employees such as civil servants.

Although house ownership rate seems to be high, second houses, summer houses and illegal squatter housing which constitute the 50 percent of the housing stock are also included in this figure.

4.3. Housing Finance in Turkey

Turkey lacks a functioning housing finance system. Indeed, it can be argued that lack of experiences of special housing finance circuits unlike other countries impedes the development a functioning system in housing finance. Although certain institutions provided housing loans, they were far from being totally specialised housing finance institutions. On the contrary, they provided housing loans beside their primary roles such as social security, commercial banking or mass housing developer. In the following section, housing finance provided by the institutions namely Social Security Organization, Armed Forces Pension Fund, Social Security Organization of Merchants and Artisans and Other Self-Employed Professionals, Emlak Bank, Housing Development Administration and commercial banks which have substantial contributions to housing finance are discussed in detail.

4.3.1. Social Security Institutions

Social security institutions such as Social Security Organization, Armed Forces Pension Fund and Social Security Organization of Merchants and Artisans and Other Self-Employed Professionals which were allowed to give housing loans according to their foundation laws supported ownership by providing housing finance to their members. However, these housing loans were limited due to the lack of funds and a limited group of members could benefit from these subsidized housing loans (Keleş, 1997).

4.3.1.1. Social Security Organization (SSK)

The Social Security Organization (SSK) was authorised to give housing loans under the law numbered 5417, which was enacted in 1949. The 20 percent of premiums were devoted for these loans. The loans were provided to the building cooperatives established by at least 30 members of SSK who were covered by its health insurance and pension schemes. The members who paid premiums for at least 1800 workdays could benefit from these loans. (Türel,1994)

These loans were allowed to be used for dwellings smaller than 100 m2 and up to 90 percent of the construction costs. The loans were given for a period of 20 years for the houses smaller than 85 m2 and 15 years for the houses 85-100 m2 with an interest rate of 5 percent per annum. (Gürbüz, 2002)

SSK provided housing loans between 1950 and 1984. Although it was not allowed to provide new loans after 1984, its financial commitments to the building cooperatives of its members, which were undertaken before 1984 had continued until 1990s. Between 1963 and 1992 SSk provided finance for 233,000 dwelling units. (Türel, 1994; Teker, 1996; Uludağ, 1997) It is argued that effects of the housing loan policy of SSK until 1984 had deepened the serious financial problems of SSK (Türel,1994; Uludağ, 1997)

4.3.1.2. Armed Forces Pension Fund (OYAK)

Armed Forces Pension Fund (OYAK) which was established in 1961 has been providing loans since 1963 to members who will purchase or construct houses by themselves or via housing cooperatives. The building cooperatives that had 20 members of OYAK could benefit from these loans. Also, personal loans have been given to its 20 year-members and to the members who bought the houses constructed by OYAK.

Between 1963 and 1992 OYAK financed 55,000 dwelling units with an interest rate of 5-7 percent until 1984. Interest rates were gradually raised to 20 percent by 1990. The 15 years repayment period was shortened to 10 years in 1983. (Uludağ, 1997)

Due to the increase in the number of members and well management of funds OYAK, without facing any financial difficulty has continued to provide housing loans up to 60.000 YTL in the forms of individual housing loan, cooperative housing loan and mass housing loan for houses constructed by Oyak Insaat. In 2005 Oyak provided loans to 2.122 members and the total amount of loans were 67.6 million YTL.(OYAK, 2005)

Beside housing loans, “Housing Savings Fund” was set up in 1996 “to make it possible for OYAK members to save up the down-payment they would need to buy a house of their own.” (OYAK, 2004) The Fund's sources are additional 10 percent contributions of its members.

4.3.1.3. Social Security Organization of Merchants and Artisans and Other Self- Employed Professionals (Bağ-Kur)

Social Security Organization of Merchants and Artisans and Other Self-Employed Professionals (Bağ-Kur) was a credit source in the 1976-1980 periods beside SSK and OYAK. The first condition for housing loan was 5 year membership to Bağ-Kur without any premium debt. The loans were given to the building cooperatives established by at least 15 members who did not own a house. The loans were given for 80 percent of housing costs with an interest rate of 5 percent for a period of 15 years. (Türel, 1994; Uludağ, 1997)

However the Bağ-Kur had to stop giving housing loans due to rapidly increasing financial problems of the security fund caused by the inflationary environment. Nevertheless this institution financed 2,7 percent of total private housing investments in the 1976-1980 period via its housing loans (Türel,1994; Uludağ, 1997)

4.3.2. Emlak Bank

Emlak ve Eytam Bank was established in 1926 in order to support and finance building sector and was reorganized “to increase its effectiveness” under the name of Emlak ve Kredi Bank in 1946. (Türel, 1994)

The duties of the bank were to provide home loans, to produce and sell houses, to construct low cost dwellings for the people without houses, to provide mortgage bonds, to encourage the building material industry and trade . Besides, the bank was authorised to take deposits and provide commercial loans beside housing loans. (Türel, 1994; Uludağ, 1997)

Until 1984, the bank gave some of the housing loans under a contractual system in which a quarter amount of the loan demanded had to be deposited in the bank for six months in order to obtain housing loan. The loans were 1,5 fold of the deposited amount with an interest rate of 5 percent up to 20 years. The interest rate of the loans was fixed rates irrespective of the inflation. Emlak ve Kredi Bank also provided loans to the buyers of the houses developed by the bank itself. The resources of housing loans given by this bank were special taxes, transfers from national budget and foreign credits guaranteed by the government. Nevertheless, the bank was unable to create a significant amount of resources for housing finance in the 1963-1980 periods and only 4 percent of the total private housing investments (excluding land cost) were financed by the bank. (Türel, 1994; Uludağ, 1997; Gürbüz, 2002)

Emlak ve Kredi Bank was reorganized and merged with another bank (Anadolu Bank) under the name of Emlak Bank in 1988. In this period, similar to Brazil income fund, a contribution of a fixed amount by employers in both the public and private sectors on behalf of employees, called 'assistance for home ownership of employees' had began to be deposited to the bank in order to be used in housing finance credits. (Türel, 1994; Uludağ, 1997)
The demand for this fund from the employees was very low since the funds could not be used for the finance of houses greater than 75 m2. Beside this, there was another reason for low demand as Türel (1994) states “However, assistance for each employee has been too small with respect to the construction cost or the purchasing price of a dwelling unit (the construction cost of 1 square metre of housing can only be financed by 18 months of contributions on behalf of an employee)”

The contributions of employers continued to accumulate in Emlak Bank, and the total amount reached to the amount equal to the half of the deposits of the bank in 1992 (Uludağ, 1997) In 1992, Emlak Bank began to give housing loans not only for newly built housing but also for owner builders with a fixed monthly interest rate 5,5 percent for a maximum period of 20 years. The source of these loans were the contributions of employers for 'assistance for home ownership of employees' deposited in Emlak Bank. According to Türel (1994:211) this source was not used convenient to the purpose;

> in order to reduce the cost of this source, Emlak Bank deposits this money in a six-monthly deposit account paying 48% annual interest when other banks offer between 68 and 76% interest rate for all six-monthly deposits. In other words, a big sum of money which is collected for a particular purpose but not used as intended, is first devalued and then used for financing mortgages, not necessarily of wage earners employed in the public and private sectors.

Beside this, Emlak Bank gave foreign currency denominated housing loans in the early 1990s. However 1994 financial crisis and devaluation of Turkish Lira affected the bank since the defaults in housing loans had increased enormously and the bank was forced to lay up the housing loans by 1995 (Erol and Patel, 2005).

Emlak Bank extended housing loans for housing units constructed by the bank, constructed in joint-partnership of the bank with developers and constructed by other builders. 56 percent of the loans were given for the houses constructed by other builders and the dwellings constructed by the bank had a share of 40 percent of all housing loans extended by the bank. (Erol and Patel, 2005)

In 1998, Emlak Bank began to extend housing loans of which the interest rates were indexed to the civil servant's salary index in order to operate in a high inflationary environment especially for the purchase of the houses developed by the bank. These loans had 10-year maturity with a maximum loan-to-value ratio of 75 percent. It is argued by Erol and Patel (2004) that the reason for indexation of instalments to civil servant's salary income was "to maintain the affordability of the mortgage for this group of borrowers".

Emlak Bank was the leading housing loan lender beside having two other functions as residential construction and commercial banking. This bank was the only bank that had the legal authorization to participate in joint venture of residential construction business given by Turkish Banking Act. In other words, it operated both as a lender and developer in housing sector. It raised funds from the sale of own built houses. This method of fund raising is used by TOKİ recently in order to fund social housing projects.

On 06.07.2001 the activities of Emlak Bank was decommissioned by the government under the law of 4684 and Cabinet decision number 2001/2202, and its banking assets and liabilities were taken over by another state-owned bank namely Ziraat Bank as a part of economic program implemented as a result of 2001 economic crisis. The assets and liabilities related to the activities as real estate developer and shares of Emlak Bank in three affiliated companies, which were not operating in the banking sector were transferred to TOKİ.

Although Emlak Bank was the only financial institution specialised in housing finance, its share in institutionalized housing finance system was between 5-19 percent during the years it had operated. The reasons behind this failure were not only unstable economic conditions such as high inflation and interest rates and lack of necessary funding for housing loans, but also targeting a small group with high income level and financing of luxury housing which were affordable only for this group.

4.3.3. Housing Development Administration (TOKİ)

As a consequence of the influences of the economic crisis in capitalist countries in 1970s, inflation began to rise in the second half of the 1970s in Turkey, but bank interest rates did not increase as much as inflation and the demand for housing rose rapidly as investment in real estate became a way of protection of savings against inflation. Additionally, housing finance institutions (such as SSK, Bağ-Kur) continued to give new credits without raising their interest rates in that period.

On 24 January 1980 an economic stabilization programme aiming 'to liberalize the economy by reducing the role of the state' was put into practice. As a consequence of this programme, interest rates granted by banks and bankers (private money dealers) for deposits increased over the inflation rate. In contrast to the 1976-1980 periods, the demand for real estate decreased very sharply during the 1980-1982 period because the savings were deposited in banks and bankers. More important than this, the real wages had decreased with the implementation of the economic stabilisation programme. As a result, decrease in housing demand led to falls in house prices and housing sector went through a financial crisis. (Türel, 1994). As it is expressed by Türel (1994:205):

> State intervention in order to take the housing sector out of crisis was in the form of creating a new housing finance system under the direct control of the government. Two successive mass housing laws were enacted, the first one by the military regime in 1981 and the second one in 1984 by the newly elected parliament.

In the first mass housing law numbered 2487, it was stated that at least 5 percent of the income of the national budget had to be transferred to a fund each year. This fund would be used to finance large scale housing projects to be produced on lands developed by the Ministry of Reconstruction and Resettlement (MRR).

MRR was attributed duties such as being the developer of publicly owned land and finance institution for both the supply and demand side of the housing sector.

However, in 1982 Ministry of Finance could only transfer 1.1 percent of the income of the budget to the fund, and the transferred amount decreased to 0.7 percent in the following year. As a result MRR could not carry out the duties given by the first mass housing law. (Keleş, 1997)

In 1984 the second mass housing law numbered 2985 was enacted. According to this law Mass Housing Fund (MHF) was created as the principal source for housing loans of which the resources would come out of taxes like charges on certain goods and services which were regarded as luxury consumption items. Housing Development Administration (TOKİ) has founded in order to manage the MHF in the same year. The revenues of MHF were used via TOKİ which were off-budget (Akçay, 2003). The housing loans were given through Emlak bank and other two commercial banks namely Pamuk Bank and Vakıf Bank with the guiding lines of TOKİ and the fund resources of MHF. The housing loans were given for 15 years at fixed interest rates between 15-25 percent according to the size of the houses. The interest rates were higher for greater houses. (Türel, 1994)

In the 1984-1992 periods TOKİ accepted loan applications for 863,000 dwelling units. About 85 percent of these dwellings were built by housing cooperatives. As housing cooperatives had been favoured in credit allocation (since there are regarded as not profit seeking organizations and contributors to planned urbanization), the members of housing cooperatives and share of cooperative housing increased very rapidly in 1984-1989 period.

TOKİ also provided 'personal loans' to be used for purchasing or building own dwelling. However, the condition to get personnel loan was depositing 15-25 percent of the amount that would be received as credit in one of the dealer banks for an unspecified period of time. TOKİ stopped giving personal credits after 1989. The number of personal credits extended was 93.215 (www.toki.gov.tr)

TOKİ has played an important role in housing finance through the 1980s despite the political pressures on the allocation of credits. However the number of loan applications accepted by TOKİ decreased by the years due to the lack of financial sources of the administration. In addition to this, the increase in construction costs led to falls in loan-to-value ratios of TOKİ credits. In other words, the loans given by TOKİ could meet 97 percent of construction cost of a 100m2-dwelling in 1984 and this ratio decreased to 15 percent in 1991.

The main reason behind TOKİ's financial difficulties was the transfer of 30 percent income of TOKİ to the national budget in 1988 and 1989. The TOKİ's income transfer percentage increased to 50 percent in the following years. The other important reason was the high inflation rates diminishing the real values of credits (and repayments) given at fixed rates irrelevant of inflation.

Under the pressure of these financial difficulties, a new housing credit system had been introduced by TOKİ in 1989. The system was called "dual-indexed mortgage system" which was designed to operate in an inflationary environment. The credit amount was indexed to inflation and repayments were indexed to civil servant's salary increase rates. Indexation was carried out according to the salary increases of the civil servants for every six months. The monthly repayments were adjusted for the 30 percent of the average wage in the public sector. It is argued that the aim of TOKİ with this implementation was "to avoid facing the problems which may arise if incomes (and repaid amounts) increase less than the rate of inflation". (Türel, 1994)

However, due to the expectation of the parallel increases in inflation and salary increases in the long run, indexation was reduced to civil servant's salary index.

Between 10 and 35 discount was made for the people who paid the outstanding amount at once.

In 1993 the transfer of all TOKİ's incomes and revenues in the national budget precluded this institution to function as a housing finance institution. Additionally, in 2001 mass housing fund was totally abolished. TOKİ has become totally dependent to its own resources.

With the government's Emergency Action Plan in 2001 TOKİ's function in housing was revitalized. Currently TOKİ creates resource with revenue sharing projects and produce social housing for low income groups. As it is stated by the interviewee from TOKİ who is the department manager in Strategy Developing Department:

> "TOKİ plans to produce 250 thousand houses till the end of 2007 in accordance with the government's Emergency Action Plan. So-called prestige projects [revenue-sharing projects for creating resource] are included in this number. In big cities the projects, based on revenue sharing are built on lands provided by TOKİ. The receivables of TOKİ irrelevant of sale performance are ready and they are transferred to social housing projects. Indeed TOKİ is the only institution that supply housing for the real needy people. I think the involvement of a public institution in housing issue is very important since the guarantee of state for both the builder and buyer exists."

Recently, TOKİ extends housing credits via developers and cooperatives with an interest rate indexed to civil servant's salary increases for a period of 10 years for the houses up to 100m2 and civil servant's salary increase rates plus 10 percent with 5 years maturity for the houses that are 101-150m2. TOKİ has extended 944.347 housing credits between 1984-2005.(www.toki.gov.tr) On the other hand, TOKİ also plays an important role in the supply side of housing and contributes housing finance for supply side, such as providing credits for developers and cooperatives and real estate builders. TOKI coordinates with commercial banks supplying credits to real estate developers.[24]

TOKİ's revenue for housing finance mainly depends on its source development projects in big cities and finance its social housing projects for low income level households with these revenues. The interviewee from TOKİ states that

> "TOKİ creates its own fund resources and finance social housing without any cash allowances from the budget but this does not mean that there is no resource transfer from the state. TOKİ took over the land portfolio of Land Office when it was abolished, for instance, TOKİ uses this land portfolio for this purpose [providing resource]. [It] took over Emlak Bank's assets except banking activities, for instance. All these mean serious resources for our institution. TOKİ use was not lack of cash I mean"

TOKİ has been also given the authority and duty to take over housing loans extended by commercial banks in order to securitize mortgage backed securities to support the formation of secondary markets beside funding the primary markets according to the public act published on the official gazette dated 18.04.2002 number 24730. Although by this public act it was aimed to create funding for housing finance, to develop mortgage loans and to deepen the capital markets, this duty was never accomplished by TOKİ. (Kendir Tunalı, 2004) The interviewee from TOKİ explains this process as

> "TOKİ has securitization authority according to the public act and mass housing law. A section under the name of securitization is inserted in the public act in order to take over commercial banks' [housing] loans and constitute receivable portfolio. It is quite important, it was stated in the initial periods of the draft law preparation. Now it seems after the constitution of legal framework it will not be required …. It was never accomplished. But there is no specific reason. Actually, the priorities and concentration of TOKİ has changed with the emergency action plan. Under the name of housing mobilization the quantity targets are determined. It is

[24] According to the protocols between TOKI and banks namely Şekerbank, Halkbank and Vakıfbank, these banks serve as guarantors and in the condition that developers delay payments of these credits, banks pay the loan to TOKI and claim the amount from the developer.

> concentrated on housing production and we need immediate resource for this production. But [it is thought] securitization is a long term issue for resource creation."

As a conclusion, TOKİ is the only public institution both acting in supply side as a developer and demand side as loan provider for housing and its role in housing issue totally depends on the housing policies of the state as the interviewee stated "the efficiency and effectiveness of this institution is directly related to priority and importance given to housing in the government programs".

4.3.4. Commercial Banks

In Turkey, according to 50th article of the Banks Law dated 23.06.1958 numbered 7129 commercial banks[25] were forbidden to lend housing loan on mortgage until 1979. It has been generally argued that due to this regulation the implementation of housing loans on mortgage and establishment of a long term housing finance system including banks were impeded.

However, with the decree law numbered 28, published in the official gazette dated 31.08.1979 numbered 16740, the 50th article was amended and the prohibition of lending housing loans on mortgage by banks was abolished. According to the new regulation, banks were allowed to lend housing loans on mortgage not only individuals but also give credits to building sector in order to support the housing sector.

But, with 50th article of the Banks Law numbered 3182 dated 25.04.1985 the credits that could be lent to the building sector were limited to social housing. On the other hand, this limitation was removed and any kind of credit that could be lent to building sector was prohibited with the decree law numbered 512 published in the official gazette in 16.09.1993.

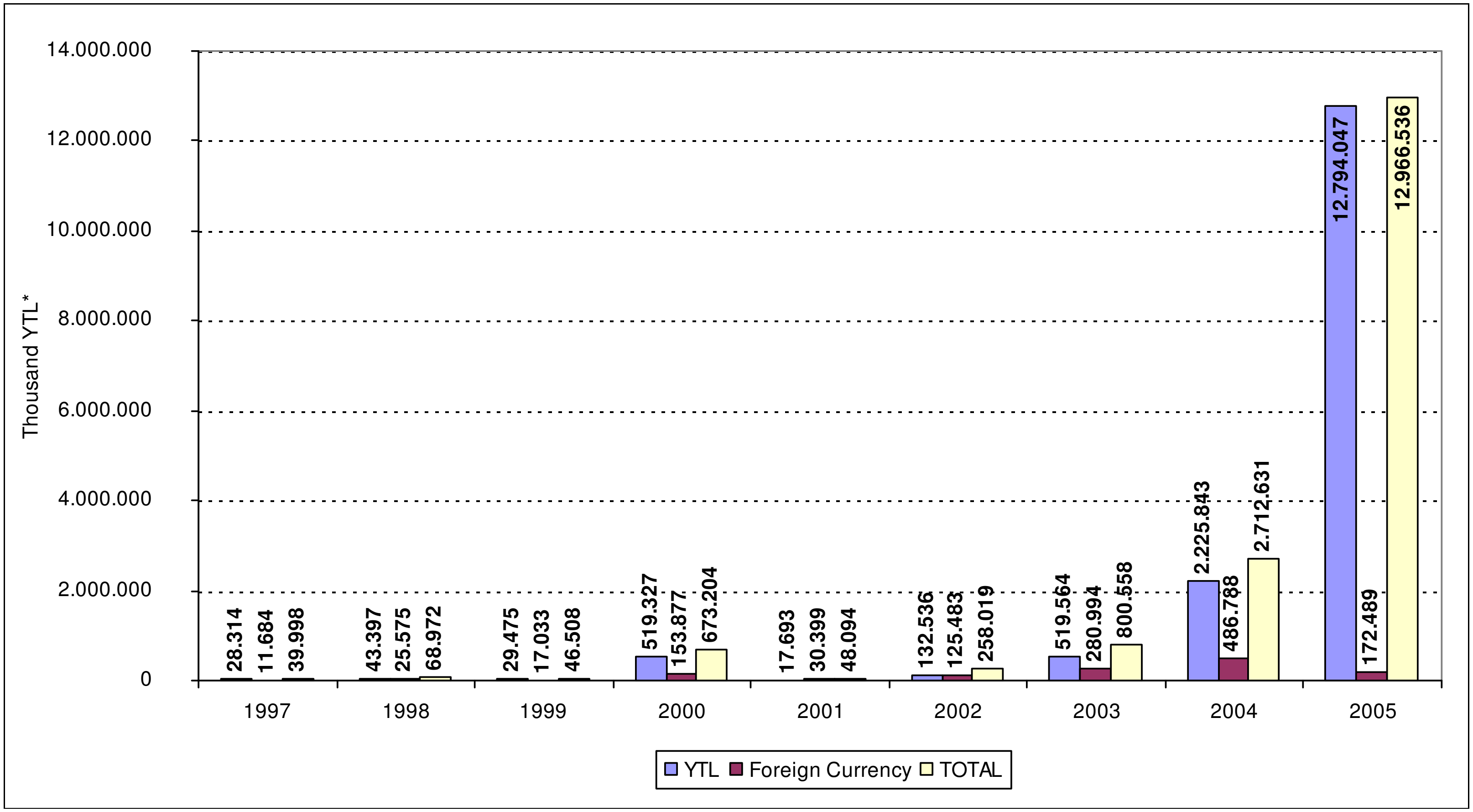
[25] Beside Emlak Bank, Vakıfbank and T. Ogretmenler Bank were exempted from this prohibition. But they did not lend housing loans on mortgage due to the unsuitable economic conditions.

Although banks were prohibited to make loans to building sector with the 12th article of Banks Law dated 18.06.1999 numbered 4389, the existing Banking Law dated 19.10.2005 numbered 5411 excluded this issue. Nevertheless, according to the current regulation, the banks may lend housing loans as a type of consumer loans.

Even though by removal of the provisions prohibiting extension of housing loans the legal barriers were eliminated, the banks were very reluctant to give long term housing loans because these loans were non-profitable within the existing economic conditions. Commercial banks gave only 14.000 housing loans in the period of 1984-1990 except the credits provided by TOKİ with the intermediary of the banks. (Kendir Tunalı, 2004) The main reason was the negative effects of high level of inflation on long term credits.

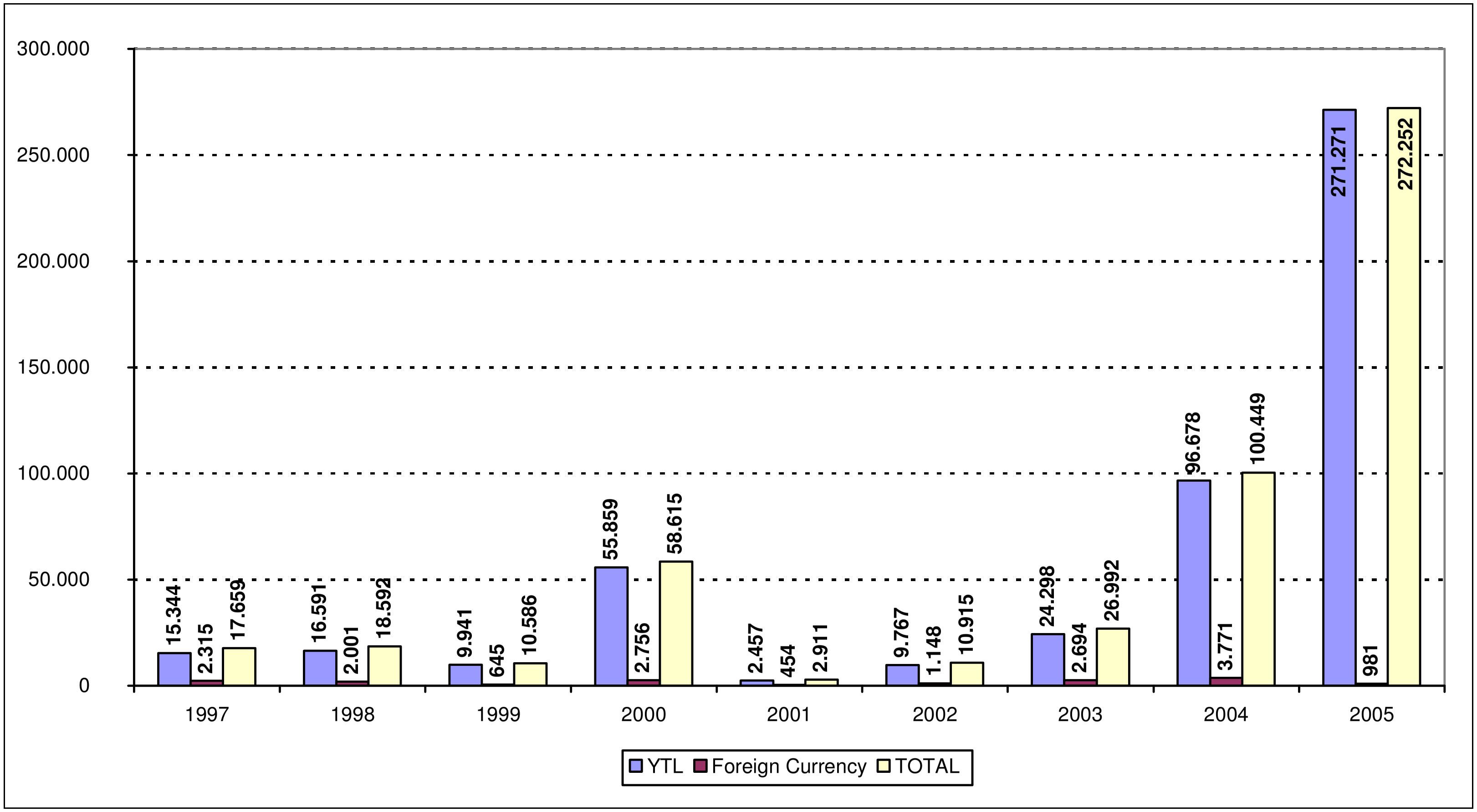
After 1990, commercial banks began to advance credits to house buyers in the form of consumer loans. However, this was rather an expensive type of housing finance for the households since the monthly compounded interest rate was 5,5 percent for a one year repayment period, and it reached to 6-7 percent for the maximum 3 year repayment period. (Türel, 1994)

Since 1990, the amount and number of housing loans have changed pursuant to the economic environment. The housing loans lent by banks decreased when the interest rates increased in respect to high inflation and when Turkish Lira devaluated. During the periods in which relatively better economic conditions existed the consumer loans especially the housing loans increased. As it can be seen in Figure 4.3. and Figure 4.4. the number of the borrower of housing loans decreased in 43 percent in 1999 due to the Asian Crisis in 1998 which led to increase in inflation and interest rates. The amount of credits borrowed decreased about 22.5 million YTL.



Source: TBB (Bank Associations of Turkey-Türkiye Bankalar Birliği) (*TL amounts are converted to YTL)

Figure 4.3. Housing Loans in Turkey (Amount)



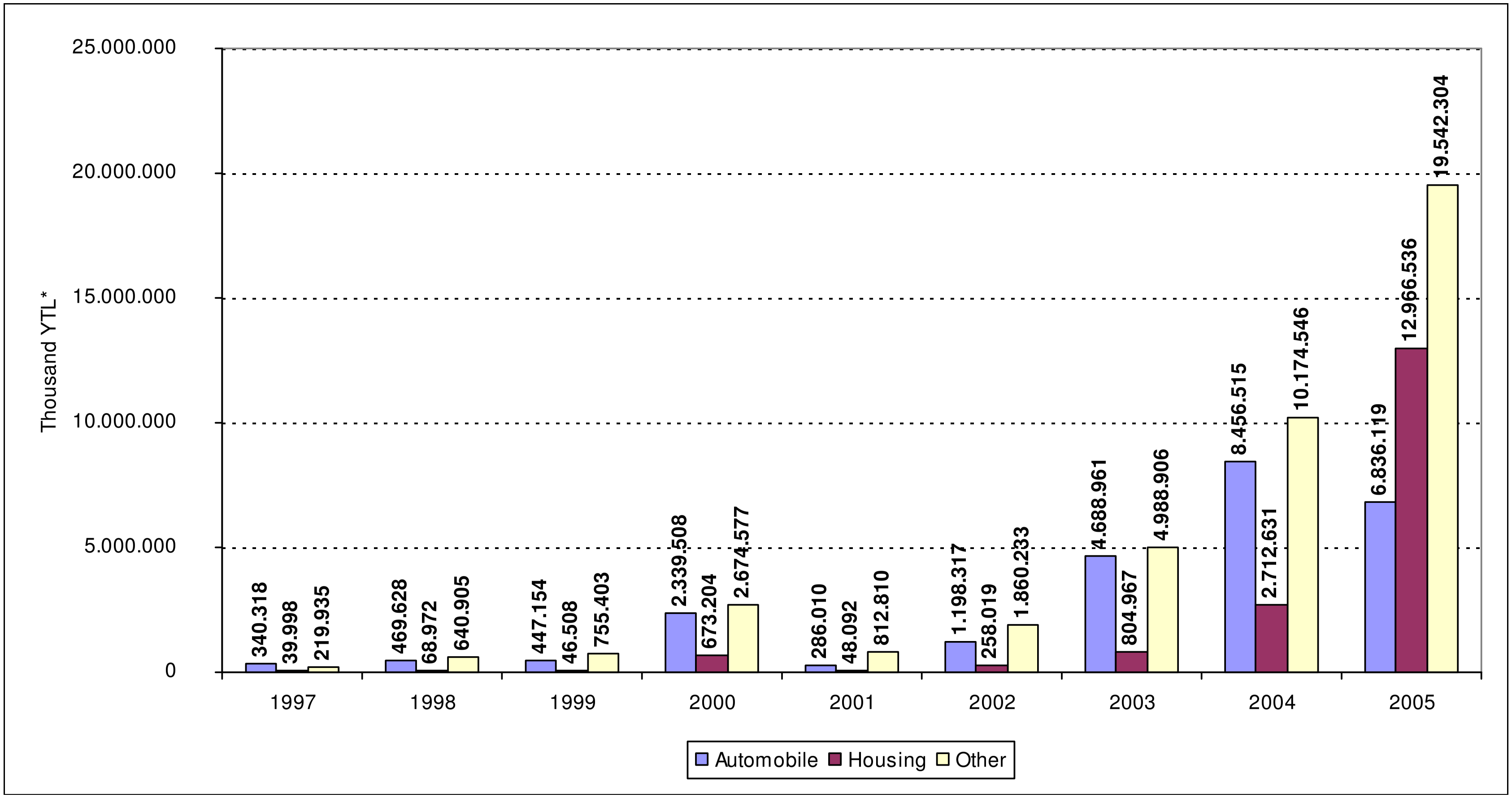
Source: TBB

Figure 4.4. Housing Loans in Turkey (Unit)

In the early 2000s, the housing loans began to expand rapidly as a result of the changes in investment policies of commercial banks. Until the late 1990s, the government was borrowing at high rates and banks were able to earn high income by investing in government bonds. Central Bank of Republic of Turkey introduced a three year monetary program to combat with high inflation. With this program the upper limits of foreign exchange rates were determined. Almost all commercial banks supported this program and interest rates began to fall. As the supply of high-income government bonds diminished, banks moved into both commercial and consumer loans.

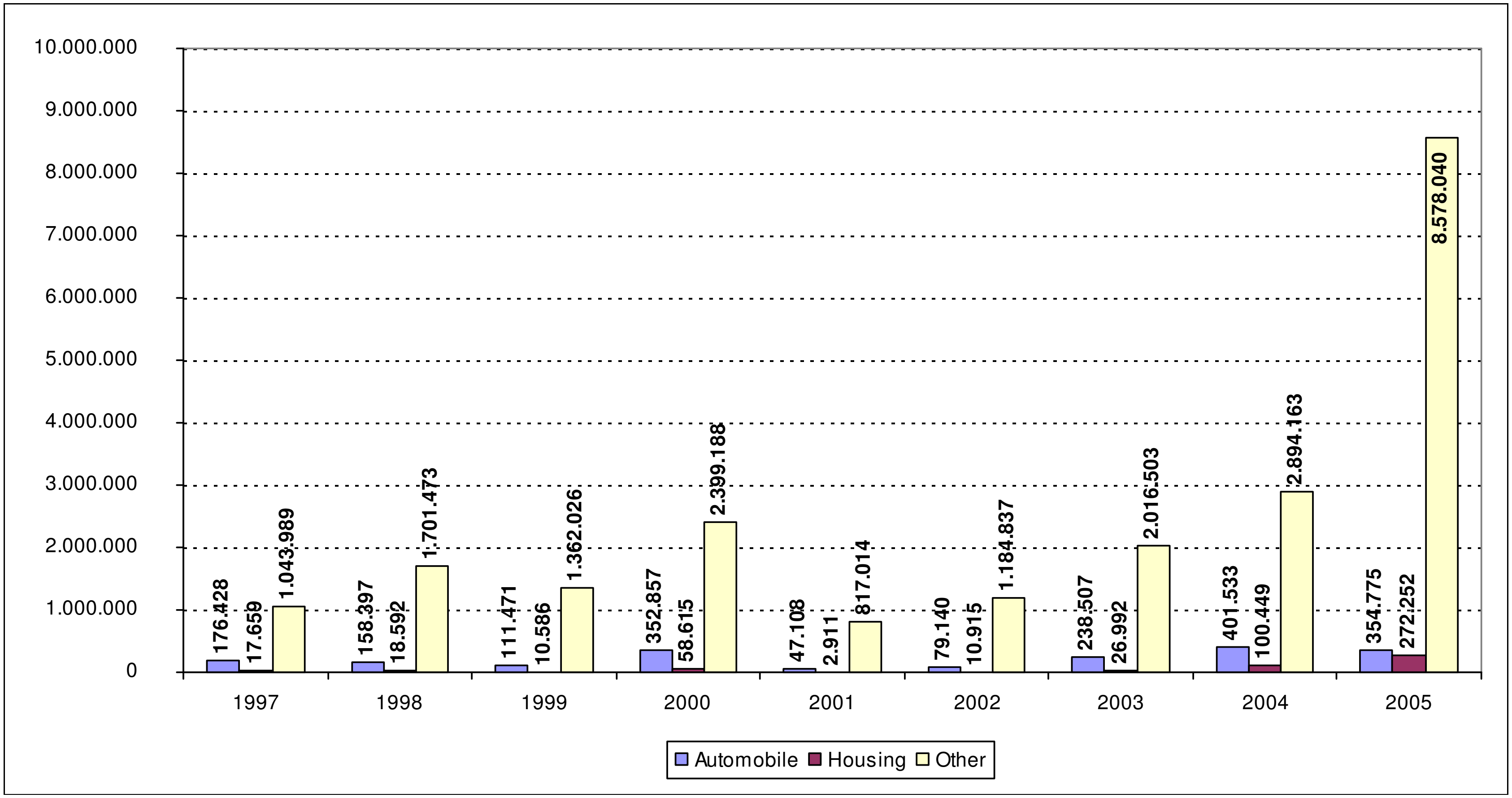
Not only banks but also individuals changed their investment patterns since the interest rates given to saving deposits were gradually decreasing and the foreign exchange rates were nearly stable. As a consequence, real estate became a popular investment tool and led to increase in demand for housing loans. The value of the housing loans jumped from 40 million YTL (US$195 million) in 1997 to 673.2 million YTL in 2000. The number of housing loans increased 5.5 fold and total housing loan amount to 14 fold in 2000 compared to the previous year. The maturity of loans also extended. Vakıfbank, for instance, lent housing loans with 2,5-4 percent interest rates up to 20 years of maturity.

However an economic crisis occurred in February 2001 which caused devaluation in Turkish Lira. Interest rates sharply increased and positive improvements in housing finance in respect to commercial banks altered adversely. (Akçay, 2003) Housing loans with fixed interest rates for the long term caused losses for commercial banks although they stopped lending loans. As it can be seen in Figure 4.5. the consumer loans especially the housing loans felt very sharply in 2001.



Source: TBB (*TL amounts are converted to YTL)

Figure 4.5. Consumer Loans in Turkey (Amount)



Source: TBB

Figure 4.6. Consumer Loans in Turkey (Unit)

Government put into effect another economic program supported by IMF after the crisis. Floating exchange rate was one of the most important policies applied. After the stabilization of exchange rates and interest rates, the inflation rate began to decrease as it is planned in the economic program. The falls in inflation and interest rates increased the demand for loans especially the housing loans since the economic environment became convenient for long term lending for commercial banks and borrowing for consumers.

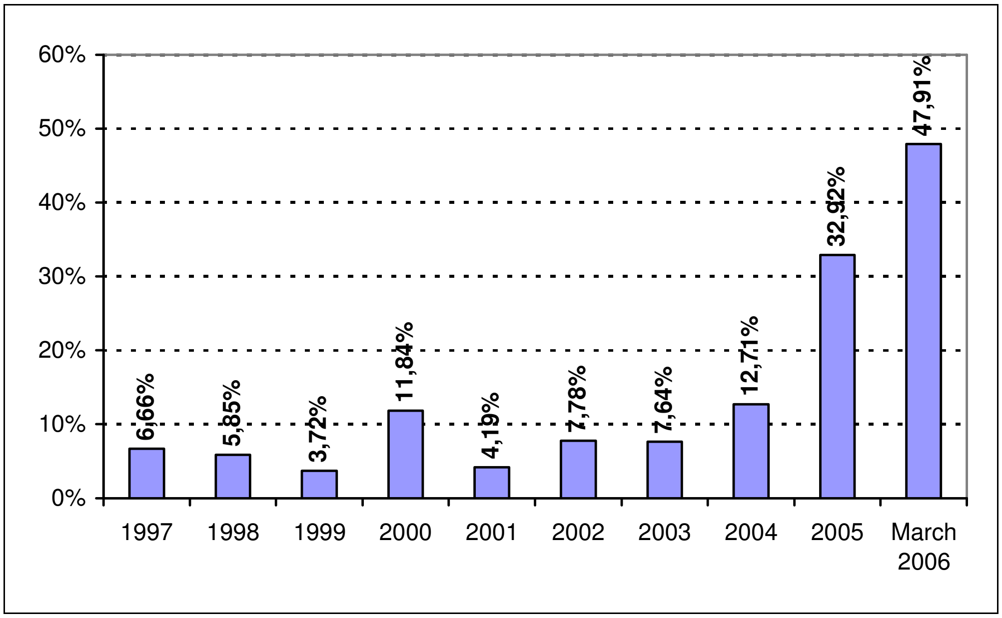
As a result the consumer loans portfolio of the banks grew by 152 percent per annum. According to Karakaş and Özsan (2005b,) “2003 was a key year as due to the improving macroeconomic outlook, further progress towards EU membership accession, and a 3-year stagnancy in housing prices, demand for housing loans rose”. The result was a serious boom in housing loans. The housing loans reached to approximately 12,97 billion YTL (US$9.8 billion) by the end of 2005. Although the volume of housing loans is still small in comparison with many other countries, it has increased 27-fold from December 2002 to December 2005.

In the first 3 months of 2006 the housing loans continued to increase due to the lower interest rates in respect to better macro economic environment[26]. The housing loans reached to 16,2 billion YTL.

However in the middle of May 2006 the outlook for economy began to change. The exchange rates began to increase very sharply. The US dollar gained nearly 25 percent values. It is argued by economists that the main reasons were increasing inflation rate and foreign trade deficit that caused the outflow of foreign capital. Additionally some global economic changes such as interest rate increases in the USA and high inflation rates in developing countries speeded up

[26] On the other hand with the decreasing real interest rates the opportunity to get syndication and securitization credits from abroad with lower costs increased and made positive contributions to the increase in housing loans

this process. Due to these changes in Turkish economy the interest rates of the housing loans also raised in two mounts nearly to the previous year levels.

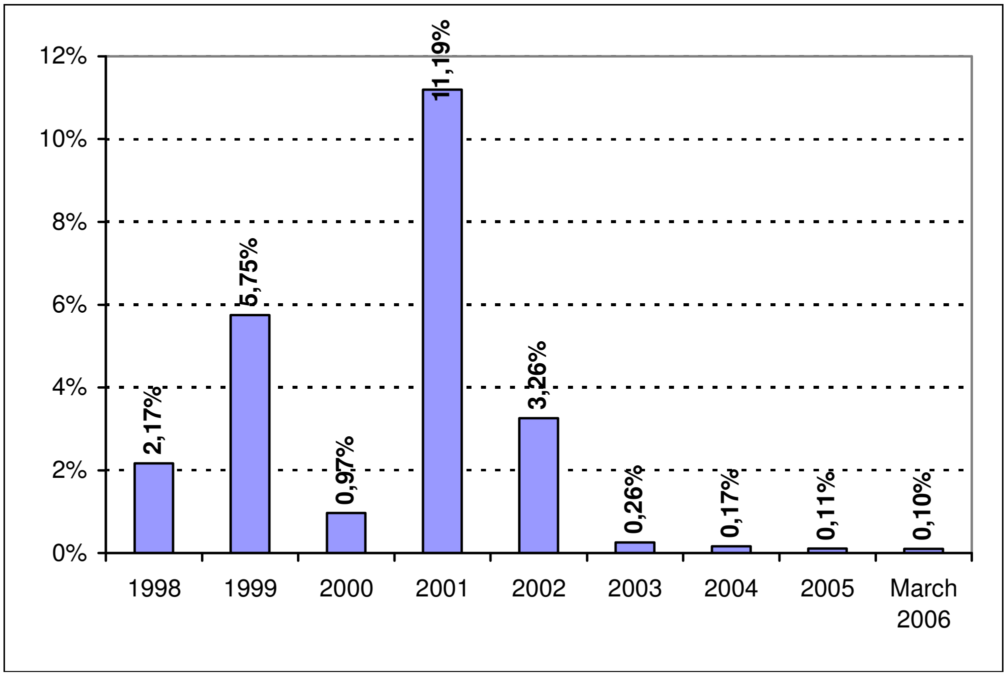


Source: TBB

Figure 4.7. Housing Loans in Total Consumer Loans in Turkey

In the periods when inflation and interest rates has begun to decrease the share of housing loans in total consumer loans has increased. On the contrary, the share of housing loans has decreased in total consumer loans when the macro economic conditions have been relatively worse.

It is argued by Kendir Tunalı (2004) that this is directly related to the maturity of loans. The maturity of housing loans should be longer than other loans since the housing is the most expensive consumption unit for the household and in order to afford housing, large amount of capital is needed. In the periods with low interest rates, the maturity of loans given by commercial banks extends, the instalment amounts paid by the borrowers decreases and the demand for housing loans increases. On the other hand, the maturity of other consumer loans rarely changes in respect of interest rates.



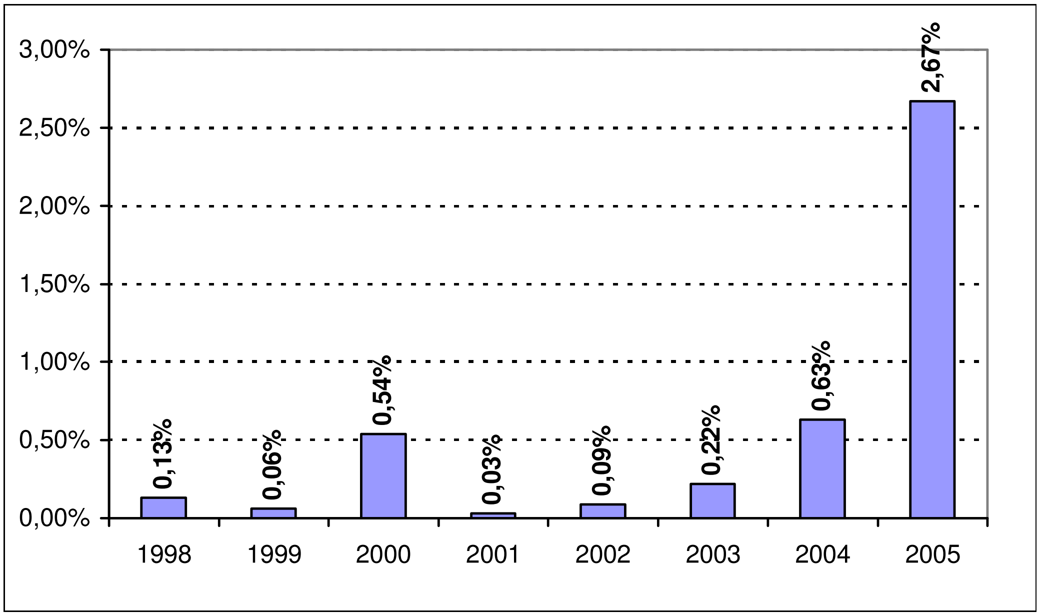
Source: TBB

Figure 4.8. Housing Loan Ratio Under Legal Follow Up in Total Housing Loans in Turkey

Another important issue related to the housing loans is that in the worse economic conditions such 1999 and 2001 the ratio of housing loans under legal follows up were very high compared to other years. These years were also the periods that housing loans decreased very sharply. On the other hand, as it can be seen in Figure 4.8., since 2003, the housing loans under legal follow up in total housing loans is under 1 percent. The reason of low number of housing loans legally followed up is that; the borrowers of housing loans are in high income group of households. The interviewee from SPK who is the specialist in housing finance project team states that,

> "Of course there are risks such as job losses and revenue losses in the periods of worse economic conditions and people do not want to get into long term debt. But the housing loans extended by banks are only affordable for selected high income groups and as a result, the number of loans per bank is only one or two files under legal follow up until now. But

> the situation may change with the decrease in interest rates of loans since more risky income groups will demand housing loans"

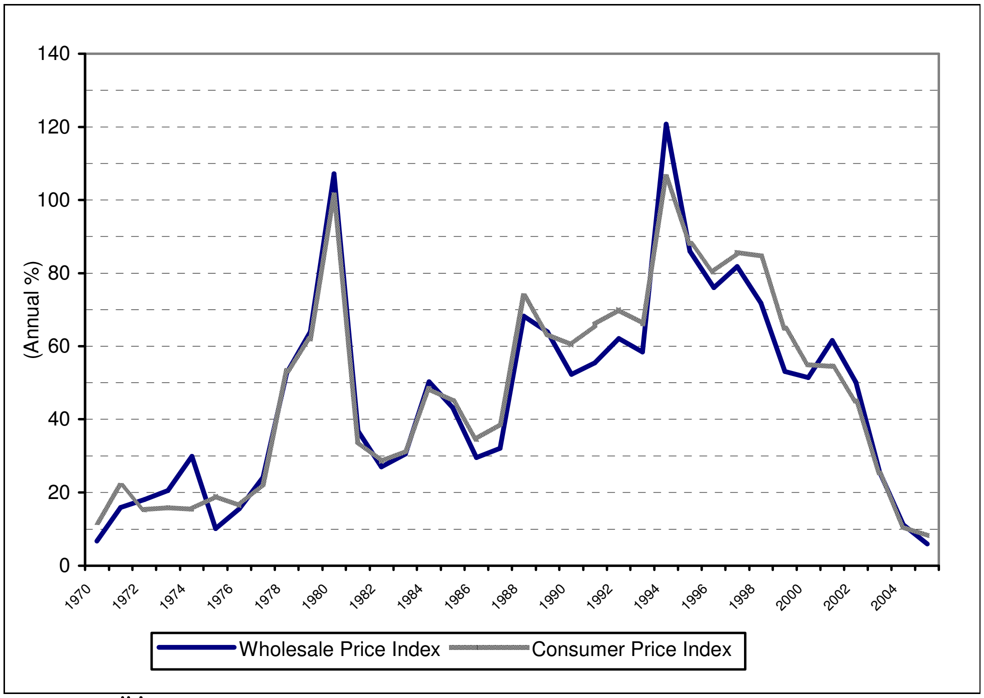


Source: TBB

Figure 4.9. Housing Loans Ratio in GDP in Turkey

The housing loans share in GDP, as it can be seen in Figure 4.9., is 2,67 percent which is very low compared to USA (69 percent) and UK (78 percent). It is argued by interviewees from SPK, TOKİ and banks that unsuitable the macro economic conditions such as chronic inflation affected the growth of housing loans volume in Turkey. The interviewee from Bank B who is a director in the bank states that

> "It was of course not possible to provide long term housing loans with low rates [that are affordable] for individuals encountering with economic crisis for nearly every 5 year periods in an high inflationary environment with enormous need of state for debt due to high budget deficits increasing the real interest rates for nearly 40 years."



Source:TÜİK

Figure 4.10. Inflation Rates in Turkey (1970-2005)

The interviewee from Bank C who is the department manager in the bank argues that the volume of housing loans are low because;

> "the housing loans are very costly for lenders due to lack of secondary mortgage markets and its is impossible to lend with low interest rates. So people have to allocate 70-80 percent of their income in order to afford [these] loans. Instead of borrowing loans from banks, they finance housing with their own resources or borrow from relatives or purchase house with instalment sales from the constructors."

4.4. Conclusion

In Turkey, housing finance and housing loans have been deeply affected by macro economic conditions like in other developing countries. High inflation, high real interest rates, low income level and low savings level, insufficient capital accumulation, high budget deficits were the basic problems those have affected the resources that can be allocated to housing loans.

Beside these unfavourable macro economic conditions, housing finance institutions specialized solely in mortgage loan lending and special circuits for housing finance have never existed in our country and housing finance have been tried to be provided by the institutions which could extent housing loans such as social security organizations, Emlak Bank, TOKİ that are publicly funded. It is difficult to mention about the role of commercial bank in housing finance neither the legal regulations have permitted commercial banks to extent housing loans nor they have been enthusiastic to give loans in unfavourable macroeconomic conditions.

Although, some of the policies applied by these institutions especially TOKİ and Emlak Bank related to housing loans were similar to the policies in other countries related to housing finance they are far from being consistent and comprehensive in practice. Until 1980, the housing loans provided by these institutions were at fixed rates irrelevant of inflation like in other countries analysed in chapter 3. Contractual system applied by Emlak Bank until 1984 and TOKİ for personal loans until 1989 for instance was a policy applied in Germany. Similar to the mandatory deposit called FGTS in Brazil, a contribution of a fixed amount by employers in both the public and private sectors on behalf of employees, called 'assistance for home ownership of employees' had began to be deposited to the Emlak Bank in order to be used in housing loans in 1988. After 1989 indexation was began to be used by both Emlak Bank and TOKİ in housing loans like in Brazilian and Colombian mortgage loans.

These policies despite their success in other countries have failed in our country because of three main reasons. First of all, these policies were not applied within a system related to housing, instead, some institutions beside their other duties were assigned to apply these policies within their own facilities. Secondly these policies were applied temporarily, in other words they were applied for short periods and discontinued due to internal factors such as managerial changes or external factors such as political interventions or economic conditions. Thirdly the unsuitable macro economic conditions such as high inflation and interest rates precipitate these policies' failure. Like in Brazil, income of TOKİ for instance, was transferred to national budget in 1988 and the following years in increasing percentages.

As a conclusion, although some efforts were put forth and adaptations from other countries' housing finance policies were made, housing finance issue was never dealt in a consistent systematic way in Turkey which have exacerbated the housing problem both in quantity and quality.

CHAPTER 5

HOUSING LOANS AND THE DRAFT LAW AMENDING THE LAWS RELATED TO HOUSING FINANCE SYSTEM

This chapter which consists of three sections except the conclusion part; one is related to housing loans provided by commercial banks from the borrowers side, the other is related to the commercial banks as the lender side in housing loans and the latter one about the draft law amending the laws related to housing finance, tries to trace the current borrowing profiles and lending attitudes and risks of commercial banks for housing loans, and the potential results of anticipated regulation namely the draft law amending the laws related to housing finance in terms of primary and secondary markets for loans in order to figure out the role of housing loans in housing finance. For these purposes, randomly selected 100 housing loan files[27] extended in Ankara by three commercial banks have been analysed in order to distinguish the borrowers' profile, housing characteristics and basic features of housing loans and in-depth interviews have been conducted with bank employees (a department manager and two directors) specialised in housing loans from three different commercial banks, with a specialist from SPK working in housing finance project group and with a department manager from Department of Strategy Developing in TOKİ which can be regarded as market actors in housing finance in Turkey. The analysis of sample housing loans extended by three commercial banks and the in-depth interviews are extensively referred in the discussions and evaluations in this chapter.

[27] It is thought that the analysis of 100 sample housing files represents the general trend in housing finance with loans since results are consistent with the literature related to housing loans extended by commercial banks. (see Türel, 1994; Uludağ, 1997; Akçay, 2003; Özsan and Karakaş, 2005)

In the following, first of all, the profile of borrowers of housing loans extended by commercial banks is tried to be explored. Secondly, the lending attitudes of commercial banks and the problems they encounter while lending housing loans are discussed in terms of current legal framework and funding process of these loans. Thirdly, the draft law amending the laws related to housing finance is discussed in the context of primary and secondary markets for housing loans. Finally a general evaluation will be made in the conclusion part of this chapter.

5.1 Housing Loans: *Who borrows?*

From the borrower's side, housing loan provided by commercial bank is almost the only way of financing a house through the institutional housing finance system in Turkey. However, the question of 'who borrows' these loans is very essential in case of discussing the role of housing loans. Perhaps, the question of 'who borrows' should be converted to 'who can access and afford these housing loans'

The answer of this question is tried to be found in this thesis with the analysis of randomly selected housing files and with the help of in-dept interviews.

According to our findings, the borrowers' profile of housing loans extended by commercial banks can be stereotyped as the borrowers are middle aged, well educated men working as wage earner with high incomes.

According to our sample group, 87 percent of the borrowers is men and the rest is women of which the age group distribution is as follows. As it can be seen from the Table 5.1. the borrowers of housing loans are concentrated in the middle age groups with an average age of 41 between 23 and 69 ages. The reason of such an age distribution is that; income of individuals increase by age in accordance with the upward mobility in working life.

Table 5.1. Age Group Distribution

	Younger than 30	31-40	41-50	Older than 50
Percentage (%)	12	36	38	14

Source: Sample Loan Files

When we look at the education level of the borrowers, more than half of them are graduated from university. Although, solely the education level is not an indicator for the borrower's profile, it can be argued that access to the institutional housing finance system is more widespread among the well-educated groups.

Table 5.2. Education

	Primary School	Secondary School	High School	University
Percentage (%)	7	6	36	57

Source: Sample Loan Files

The interviewee from Bank A who is a director in the bank states that

> "We, as a bank, prefer customers from public sector who are civil servants or workers. They have regular incomes and have job security. We consider people from private sector as risky even though they have higher incomes"

However, according to the Table 5.2. below, the sector distribution of the sample group is nearly even, 49 percent of them are employed in public sector. The ones who are employed in both sectors are doctors working both in the hospital and their office.

Table 5.3. Public sector/Private Sector Distribution

	Public Sector	Private Sector	Both Public and Private sector
Percentage (%)	49	48	3

Source: Sample Loan Files

87 percent of the sample group is wage earners and 12 percent has own business. Both wage earners and own business group consist of 3 doctors and 2 lawyers. The distribution is remarkable since one of the main problems in housing loan lending is the proof of income for the ones who have their own business since there is a trend among them to understate their income in order to pay less tax.

Table 5.4. Wage-earner/Own business Distribution

	Wage Earner	Own Business	Both Wage Earner and Own Business
Percentage (%)	87	12	5

Source: Sample Loan Files

As the interviewee from Bank A states

> "The main problem for a customer who wants to borrow housing loan is to prove his income. Taxes and social security premiums are very high in our country. Mostly the calculated monthly instalments for the housing loans exceed the officially proved monthly income"

However, the interviewee from SPK states that banks lend loans in accordance with consumer patterns of their customers;

> "The banks want to lend housing loan to their customers with informal incomes. They know these men well, they are bank's customers. Every month the statement of credit card is seen, man pays this credit card. In a way, bank knows that he has money although he can not prove officially. Even though they can not prove their incomes, banks lend housing loans by looking at consumer patterns in these cases –credit card is the first thing they look at- I mean lack of proof of income may not exclude these people. Bank knows who has money"

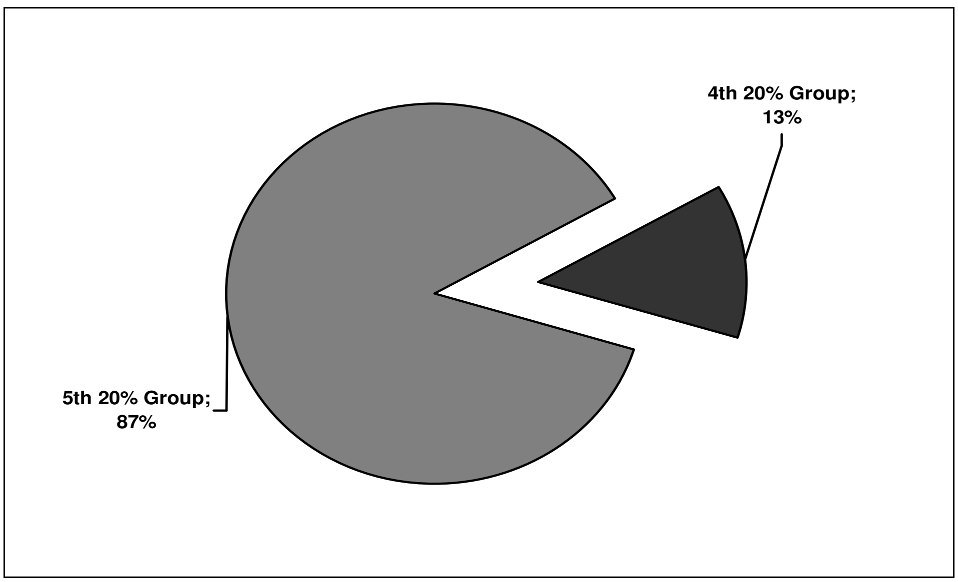
When we look at the income levels of our sample group borrowers, there is no doubt that overwhelming majority is in the highest income group of 20 percent. The income levels of our sample group are compared with the statistics of income groups in Turkey as the reference point.

In the following, quintiles ordered by income are given with the lowest and highest values of the quintiles for Turkey. According to this table, the average monthly income of households in 4th 20 percent group is 1,167 and 5th 20 percent group is 2.462 YTL.

Table 5.5 Quintiles Ordered by Income in Turkey (2004)

Household Income (YTL)	1st 20% Group	2nd 20% Group	3rd 20% Group	4th 20% Group	5th 20% Group
The Lowest	-	463	678	966	1.417
The Average	322	570	811	1.167	2.462
The Highest	462	677	965	1.416	-

Source:TÜİK



Source: Sample Loan Files

Figure 5.1. Income Groups

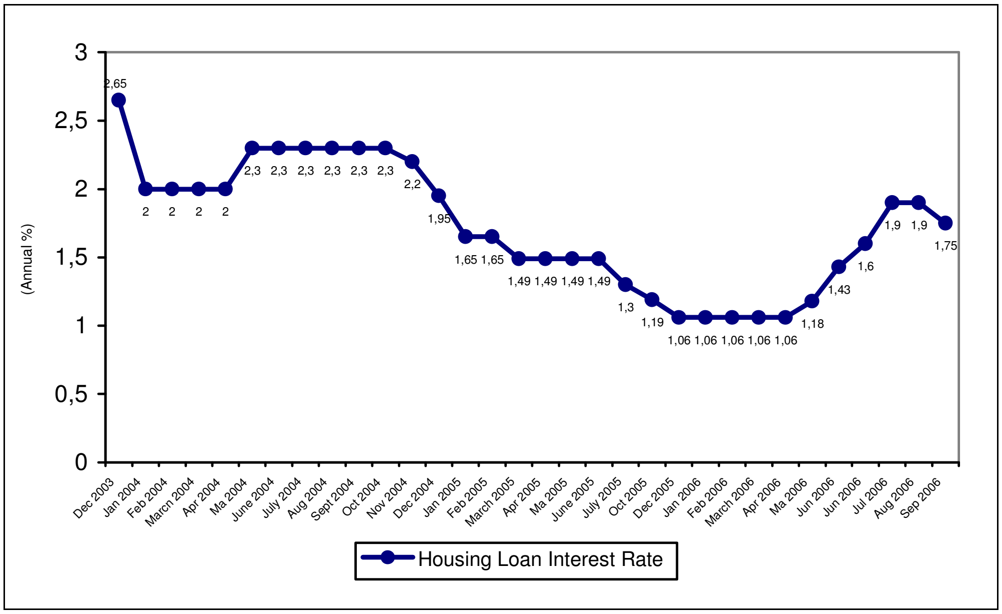
When the households' income in our sampling group is categorized according to the values of the quintiles, it is seen that 87 percent of the sampling group is in the 5th 20 percent Group. The rest belongs to the 4th 20 percent group. Moreover, the average income of our sampling group is 3.106 YTL which is notably higher than the average of Turkey.

The interviewees from commercial banks commonly state that banks do not target high income groups, instead, they target all customers who can prove that they have regular income to afford the instalment payment of loan they borrowed. But, the loans are affordable for only high income due to high interest rates and low income levels in Turkey. The interviewee from SPK argues that

> "When we talk to the bank employees, they tell that they can extent housing loans to only high income groups as they called 'A-Income Group' Anyway, with these interest rates it is difficult for low and middle income groups to afford these loans. Also, maybe people from middle income groups after accumulating a great deal of house price may borrow loan for the rest of the amount but the main [borrower] group is A income group…. It is not possible for low income group at present and in the near future to access these loans… with these interest rates"

The interest rate of housing loans has had a downward trend until May 2006 as it can be seen from Figure 5.2.[28] below. However, after a sharp increase in May and June, it has begun to fall again.

[28] The interest rate of Ziraat Bank is used in this figure because it is thought that it represents the general trend in interest rates in the banking sector due to the path-dependent behaviour of commercial banks.



Source: Ziraat Bank (Department of Retail Marketing)

Figure 5.2. Housing Loan Interest Rate

The housing loan amounts change between 8.000 YTL and 220.000 YTL with an average of 52.897.15YTL. When we look at the loan to value ratio (LTV) we see that the average loan to value ratio is 53,8/100 which indicates that the half of the price of purchased houses are financed through housing loans and large amount of down payment is needed in order to purchase a house in our country.

The payment to income ratio (PTI) of our sample group indicates that borrowers allocate 39,4/100 of their income to housing loan instalment payments on average. The 23 percent of housing loans in our sample has a payment to income ratio over 50/100 This percentage is remarkable since in the long run such ratios may cause an increase in delinquency in housing loans. The average instalment amount is 1,133 YTL. This is quite high in terms of general income level in our country which bears out the assertion that housing loans provided by commercial banks are affordable only for high income groups.

Thus, it can be stated that the prevailing arguments that housing loans given by commercial banks are predominantly affordable for high income groups (Türel:1994, Uludağ:1997, Akçay:2003, Özsan and Karakaş:2005) is still valid under the current borrowing and lending conditions.

When we look at the houses that are financed with housing loans, they are large in size with an average of 122 m2. 73 percent of these houses are three roomed, 15 percent are four roomed. There is also a misleading perception that qualified housing means larger and luxury houses in our country. The interviewee from SPK defines the qualified housing and the problem related to housing stock as;;

> "qualified housing means houses produced as earthquake-resistant and officially authorized. They may be 2 or 3 roomed…. Indeed one of the main problems for housing loans is the housing stock …. lack of credible housing. The statistics are old but, especially in Istanbul and other big cities most of the houses are not authorized and people do not have freehold flat. The house is seen as under construction but people live in it…"

As it is stated above by the interviewee the lack of qualified housing which can be credited by bank is an important problem which affects both the borrowers and lenders of housing loans.

Although the appraisal value of the houses may be different than the market value[29] the average appraisal value of the houses purchased with housing loans is 99.320 YTL with a minimum value 31.200 YTL and maximum value 280.000 YTL. 91 percent of the purchased houses is completed and ready to live in.

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[29] Some of the commercial banks have their own appraisal staff and the valuation done by this staff is quite conservative compared to the valuation done by certified real estate appraisal companies.

5.2 Housing Loans: *Commercial Banks Lend But How?*

In Turkey, housing finance is mainly provided by commercial banks[30] in terms of institutional financing through housing loans. In this section it is tried to be discussed the legal framework for these loans and issues related to funding of these loans by commercial banks.

Commercial banks give housing loans as a type of consumer loans. The article 10 of the Consumer Protection Law numbered 4077 was amended by the article 15 of the law numbered 4822, published in official gazette dated 06.03.2003. According to this amendment, the total debt amount and interest rate should be stated in the consumer loan agreement and can not be changed to the disadvantage of the consumer. Thus, this connotes that it is forbidden to extent housing loans with variable interest rates. Indeed, it was possible to extent loans with variable interest rates until the amendment date. This amendment may be regarded as a reaction after 2001 crisis in order to protect the consumers who faced with financial difficulties due to the high interest rates in the crisis period. Additionally, as provisioned in the law, prepayment penalties are also forbidden for any type of consumer loans, including housing loans. According to the interviewee from Bank B;

> "Housing loans are regarded within the context of consumer loans contrary to the European Union regulations, It creates specific problems. All over the world in none of the developing countries, there exist fixed interest rates exceeding 5 year maturity. Also, Turkey (the other exception may be America) is the only country which does not impose prepayment fee for the prepayment of a fixed interest rate [housing] loan."

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[30] Although the houses developed by TOKİ are also credited via commercial banks and cooperatives by this institution, it is out of the concern of this chapter.

The interviewee from SPK argues that

> "Consumer Protection Law limits the freedom of contract in housing loans. It prohibits the extension of loans with variable rates. When the loan is prepaid it forbids the banks to impose a penalty fee."

Özsan and Karakaş (2005b) also criticize the prohibition of variable interest rates for housing loans as;

> In order to be able to increase the market size by penetrating lower income segments there should be primary market products for households with different payment capabilities. Adjustable rate and indexed mortgages are the main products that would serve this purpose. .... Having only the fixed rate instruments to use, the market development would have been very limited.

It is argued that the prepayment fee on fixed rate loans is necessary in order to minimize the prepayment risk and to maintain a high level of investor interest in the mortgage backed securities, since for mortgage backed securities regular payment flows to mortgage pools are needed. (Özsan and Karakaş, 2005b)

According to Consumer Protection Law, the loan lending institutions are equally responsible with the building developer for product deficiencies for non-delivery, incomplete delivery and late key delivery of houses with the building developer in campaign product sales which are associated with certain building projects.

According to the interviewee from SPK it is not fair since

> "… the banks are jointly responsible with building developer for the whole value of houses for instance 100 Lira even if they lend loan for 10 lira. If the building developer does not deliver the house banks have to indemnify whole loss of the consumer as 100 lira.."

According to Consumer Law, when the borrower misses two consecutive instalment payments and does not respond within 7 days to the written notice sent by the bank, loan becomes in default.

On the other hand, the bank must establish a ‘loan loss reserve’ for the entire borrower's outstanding consumer loans after two consecutive missed payments of a consumer loan in accordance with the Banking Law. In other words, when the borrower has missed two consecutive instalment payments of an vehicle loan, this requires that the bank has to establish a “loan loss reserve” for that loan, plus for other loans extended to that borrower, for example, the housing loan that has been already paid on-time. According to Özsan and Karakas, (2005a) to be obliged to keep more reserves than necessary creates extra burden on the commercial bank which force banks to lend loans more conservatively.

According to the Banking Law, the banks are obliged to dispose the real estates mortgaged for housing loans in case of delinquency in three years. Foreclosure of the mortgages is regulated in Law of Foreclosure and Bankruptcy with the same rules applied to both commercial and housing mortgages. Although the Turkish Bankruptcy and Foreclosure law is very much in conformance with European Union standards, a foreclosure process may take up 3 years to be concluded due to the objections of the debtor. The interviewee from SPK explained this process as;

> “..The problems in foreclosure system, it operates slowly. The legal proceedings may be indulged to 2,5-3 years. [bank] sends writ of execution, [debtor] objects, [bank] institutes a suit, the debt becomes final, court expert is appointed, the value assessment of house is done, [debtor] objects, another court expert is appointed, bid for judicial sale is organized, the house is sold, [debtor] objects that it is rigged in the bidding process. There are many delaying effects and these delay foreclosure up to 2,5-3 years. It both delays and creates [additional] cost, foreclosure fees. The house can not be sold in its value. For this reason, [if] bank extends a credit for 80 Lira for a house worth 100 Lira and one day later the man [debtor] says I will no pay [the loan], the bank may foreclosure the house, maybe it lasts 2,5-3 years to take 80 lira [for the bank]. Besides the house

> is sold for 50-60 Lira in the judicial sale bid. [bank] maybe can not recover its 20 lira. There are such problems."

Housing loans are subject to taxes such as banking insurance and transaction tax and the banking resource utilization support fund[31] which creates extra cost for the borrower.

Within this legal framework, commercial banks lend housing loans with the funds they borrowed either from savers or other financial institutions. That is to say, housing loans are funded either through deposits or foreign credits such as syndication credits or securitization credits. However, deposits are the main fund resource for housing loans since the 61,2 percent of the liabilities of the banks are consisting of deposits in 2005.

Deposits held with commercial banks as the housing loan resource are predominantly short term and stating that deposits hardly reach to 2 month maturity should not be regarded as exaggeration

Table 5.6. Maturity of Deposits in Turkey (2005) (Thousand YTL)

Maturity	Amount	Percentage (%)
Up to 1 month	151.974.869	62,5
1-3 months	66.616.520	27,4
3-6 months	12.411.991	5,1
6-12 months	7.708.136	3,2
Longer than 12 months	4.409.405	1,8
TOTAL	243.120.921	100.0

Source: BBDK[32] (Banking Regulation and Supervision Agency)

[31] The housing loans given for refinance of the loan, transfer of the loan to another bank or changes in the currency of the loan are exempted from the banking resource utilization support fund since 10th February 2006 according to the directives of Ministry of Finance.

[32] Bankacılık Düzenleme ve Denetleme Kurumu

The deposits with a maturity up to 1 month constitute the largest group and the 89,9 percent of the deposits have a maximum maturity of 3 months. As it can be seen from the Table 5.1. the deposits with a maturity longer than one year has a share of only 1,8 percent in the total deposit amount.

Commercial banks' other source for lending loans is foreign credits provided from abroad. The maturity of these credits is longer compared to deposits as it can be seen in Table 5.7.

Table 5.7. Foreign Credits Provided from Abroad in Turkey (Billion USD)

Year	Syndication Credits	Securitization Credits	TOTAL
2002	2,2	1,4	3,6
2003	3,8	2,8	6,6
2004	6,5	3,5	10,0
2005	8,2	7,0	15,2
Weighted Average Maturity (Year) (2005)	1,0	6,2	3,3

Source: Doğan, 2006

Current macro economic conditions has created the opportunity for commercial banks to provide funds with longer maturities and with lower costs which means lower interest rates. As it can be viewed from Table 5.7. in 2005, an amount of 15,2 billion USD has been provided from abroad as the syndication and securitization credits. The average maturity of these foreign credits is 3,3 years which extend the maturity of borrowing for the commercial banks.

Table 5.8. Maturity of Housing Loans in Turkey (September. 2005)

Maturity of Housing Loans	YTL (Thousand)	USD (Thousand	Percentage (%)
0-1 Year	958.912	715.286	9,7
1-2 Years	1.064.888	794.337	10.7
2-3 Years	1.191.755	888.971	12,0
3-4 Years	1.174.889	876.390	11,9
4-5 Years	1.839.095	1.371.845	18,6
5-10 Years	3.143.771	2.345.048	31,7
10-15 Years	469.087	349.908	4,7
15-20 Years	74.557	55.615	0,7
TOTAL	9.916.954	7.397.400	100,0

Source: Doğan (2006)

The Table 5.8. shows that housing loans with a maturity of longer than 10 years is only 5,4 percent in the banking sector. Housing loans provided by banks are concentrated in 5-10 years maturity.

The maturity of housing loans in our sample group overlaps the maturity distribution of housing loans in whole banking sector as it can be seen below

Table 5.9. Maturity of Housing Loans

Maturity of Housing Loans	Percentage (%)
0-1 Year	-
1-2 Years	1
2-3 Years	7
3-4 Years	10
4-5 Years	23
5-10 Years	53
10-15 Years	4
15-20 Years	2
TOTAL	100

Source: Sample Loan Files

According to the Table above the maturity of loans are concentrated in 5-10 years with a percentage of 53 in our sample group similar to the whole banking sector. Likewise the whole sector, the second largest group is 4-5 years of maturity with a percentage of 23. However, the average of the maturity is 7,65 years for the housing loans and is very low compared to other developing countries analysed in chapter 3.

It is obvious that the main problem for commercial banks is the mismatch of maturities of assets and liabilities in their balance sheet which is known as maturity risk. Banks borrow short term and lend long term in housing loans. Secondly, as the housing loans are extended with fixed interest rates, commercial banks face with difficulties such as an increase in interest rates raises the cost of deposits that are short term and it can not be reflected to the long term housing loans immediately. This means the banks pay more for the funds they borrowed and they make loss. Thirdly, prepayment risk which means early repayment of the loan by the borrower may lead to difficulties for banks to arrange cash flows. Lastly, commercial banks while lending housing loans always confront a risk of non-payment which means the risk of borrowers' being defaults called credit risk.

All these risks determine the lending attitude of commercial banks for housing loans. During the in-depth interviews these risks and the current strategies in order to cope with these risks are emphasized by interviewees and. An interviewee from Bank C argues that

> "the banks try to minimize the risks they undertake with derivative instruments –hedging transactions such as futures, options, forward"

The interviewee from Bank B states that

> "Of course the banks try to minimize the risks with different financial instruments but these also increase the cost of funds for housing loans.

> Also the issues such as the lack of prepayment fee prevent the complete protection from these risks ”

The comprehensive explanation is made by the interviewee from SPK as,

> “Banks either carry these risks or try to hedge with derivative instruments, SWAP contracts. But in this case they have to pay the cost of these instruments… some of the banks make these [contracts]. For instance the banks who make this state that they satisfied when the interest rates fluctuated in May [2006], the other banks bared losses. In any case either you will hedge and tolerate the cost [of these instruments] or carry these risk with your capital. In this case you pay the cost of overcapitalization”

In order to eliminate these risks , the interviewee from bank A stated that banks lend loans with low loan to value and payment to income ratios. He says that “they try to lend more in numbers but less in quantity in order to minimize the especially the credit risk”.

The interviewees also insist on the risk-creating effect of lack of variable interest rates. According to all interviewees lack of variable interest rates transfer all interest rate risk to the lender side.

5.3. The Draft Law: *Is a Solution? If Yes, for What?*

A draft law amending the laws related to housing finance system prepared by Capital Markets Board of Turkey (SPK) was submitted to the parliament by the government on 28th of November 2005. Since than, this draft law is waiting to be approved by the general assembly of the parliament.

There are many speculations made about this draft. It has been pumped by media that everybody will buy their houses with mortgage loans instead of paying rents. Every night in primetime news, the advantages of the mortgage system that the draft law will set up has been announced with advertisements of luxury houses built by developers. It was reflected as a magical solution for the housing problem for everyone by both the politicians and media. Nowadays, its popularity has diminished but it is still thought that it has not been discussed and understood well. During in-depth interviews it is asked that what was the rationale behind this draft law and was it a solution, if yes for what. Naturally, the interviewees who are specialist in this issue stated that this draft law is not a solution but only a tool in order to promote housing loan lending in the primary markets and establish a secondary market in order to provide funds from capital markets for these loans.

When this draft law is discussed within the context of global trends in housing finance, it is explicit that it totally reflects these trends of which the most important one is integration of hosing finance to capital markets. As our country lacks specialised housing finance institutions (except decommissioned Emlak Bank) and special circuits in housing finance, the discussions for the decline of them are not meaningful in this chapter within this context.

The interviewees from commercial banks commonly state the rationale of this draft law is to eliminate the legal obstacles during lending process and necessity for establishment of secondary markets in order to diminish the risks of lending housing loans.

The interviewee from SPK as the main actor during the preparation of this draft law claims that it should not be exaggerated since it only makes some changes in the primary market that would lead to problems in case of growth in housing loan market and tries to regulate the establishment of secondary markets. As he explains

> "It was known that by providing funds from capital markets, good thing were done. But in case of 60 percent interest rates and 40 percent of inflation it was meaningless to discuss this option. This was discussed at the background, in the research reports etc. until 2001, when the interest rates has begun to fall and interest of foreign investors has increased in Turkey. We thought that if we prepare such a framework it will be

> useful….. Yes there is trend in the world. In the Philippines and in Kenya there are draft laws like this. But neither the World Bank nor the IMF has a direct effect on this draft… There is a fund called First Initiative financed by developed countries in which World Bank makes a little contribution. This fund supports similar projects. We applied this fund in order to provide funding for this project. We finance the consultant fee of the foreign consultants hired for this project with these funds. They contributed very much to this issue. World Bank's approach was rather supportive. IMF, on the contrary was against this regulation. They were afraid of negative effects of excessive demand for housing to macro economy in case of enormous increase in housing loans. They almost make suggestions which connote the limitation of lending loans….Indeed this draft law only aims to remove the imperfections in the legal framework. It was also possible to make the amendments in the related laws one by one since it does not set up a system."

It can be argued that this draft law is misunderstood in the public opinion since as it is stated by the interviewees, it neither creates a totally new system nor is the solution for housing finance issue of the people from all income groups.

In accordance with this pre-acceptation, it is aimed in this section to provide insights for the future housing finance regulations in our country with this draft law in terms of primary markets and secondary mortgage markets . In this section, the draft law will be discussed with referring to the prominent amendments made in different laws without going into technical and operational details by which the prospective housing finance system will tried to be explored.

With this draft law, legal regulatory framework for housing finance system is tried to be established by amending Law of Foreclosure and Bankruptcy[33] dated 1932 numbered 2004, Capital Markets Law[34] dated 1981 numbered 2499, Consumer Protection Law[35] dated 1995 numbered 4077, Financial Leasing Law[36] dated 1985

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[33] İcra ve İflas Kanunu

[34] Sermaye Piyasaları Kanunu

[35] Türketicinin Korunması Hakkında Kanun

[36] Finansal Kiralama Kanun

numbered 3226 and various other tax laws with the purposes of promoting primary mortgage market and establishing a secondary mortgage market in order to create alternative funding for the primary lenders. The amendments made by the draft law will be discussed under two categories as changes in primary lending and establishment of a secondary market for housing loans.

5.3.1 Promotion of Primary Market : *What is new?*

In the draft law, article 38/A definition of housing finance has been added to Capital Markets Law by which housing finance is defined as "the extension of loans to consumers to acquire houses; leasing of houses to the consumers through financial leasing; and extension of loans to consumers where such loans are secured by the houses that the consumer owns" (Capital Market Board, 2005)

This definition covers the loans extended to refinance the loans, home equity loans[37] and loans for improvement of houses if they are secured by a mortgage. Construction or project finance is also included in the context of housing finance in order to promote housing supply by stimulating housing finance institutions with tax incentives provided and secondary market opportunities

In the draft law, this definition is referred in Law of Foreclosure and Bankruptcy, Consumer Protection Law, the tax laws and Capital Markets Law itself.

In the draft law, it is stated that the primary lenders are:

1. banks,
2. participation banks (previously known as Islamic banks),

[37] Home equity loans means loans borrowed against the existing housing unit for other purposes such as capital investment, etc. "Currently, home loans are extended only to borrowers who are involved in a real estate transaction at the title office. However, the borrowers will be able to borrow home equity loans as long as that is their first or second home. By home equity loans the real estate tax collections are expected to increase significantly, as the borrowers would need to update the value of their properties at the title offices." (Özsan and Karakaş, 2005b)

3. the leasing companies and
4. consumer finance companies

The leasing and consumer finance companies are non-bank institutions. Among them the ones which are found eligible to operate in housing finance by the Banking Regulation and Supervision Agency' will be able to lend loans.

Currently, the leasing companies and consumer finance companies do not provide housing loans. Leasing companies mostly operate in investment finance, and do not have consumer products, while the finance companies provide car loans and other type of consumer loans but not housing loans. It is aimed by the draft law to give the opportunity for these companies to operate in the housing finance business with their funds (Capital Market Board, 2005). The interviewee from SPK explains this regulation as;

> "The companies applied us stating that 'we want to extend credit but do not want to be bank. We have funds from abroad, we want to bring them and extend [housing] loans. What can we do?' We [SPK] find this as a solution. This is what it must be done and it is done all over the world. Extending loans is not in banks' excessive possession. Everyone can extend loans. You must be a bank if you collect deposits. The existence of such companies will increase competition. They will compete with banks. As they will not collect deposits they will have to use capital market facilities more, either issue bonds or make securitization. These [companies] may lead to the development of secondary markets. Their function is to increase competition and investors especially the foreign who want to invest Turkey may come to Turkey. But banks complained about this subject. 'I have to deal with BDDK, I have a lot of liabilities. This man [company] will come, establish an office and extend credits without any cost. You create unfair competition in favour them' Of course they [companies] will give. But this [way of thinking] is wrong. BBDK establish obligations and liabilities not for extending loans but for collecting deposits. You establish a branch in Patnos town of Ağrı and collect deposit. That man does not have a chance like that. TMSF guarantees the deposits you collected from Patnos . If you don't pay, it [TMSF] will pay the money of citizen. You can collect deposits by putting your signboard under the guarantee of it [TMSF]. We argue with them [banks] stating that 'don't think competition in this way'"

However, according to the draft law these companies will be allowed to operate in housing finance after two years following the enactment of the law in order to adapt the secondary legislations for the convenient working environment for these institutions "since they are subject to a different set of rules and regulations which provide them with certain benefits which may cause unfair tax advantages against the banks." (Özsan and Karakaş, 2006b)

The other issue related to primary market is the regulation of consumer protection issues. Consumer Protection Law numbered 4077 enacted in 23.02.1995. The draft law makes amendments in Consumer Protection Law which aim to lighten the restrictions of the existing regulations and to introduce some further consumer protection methodologies such as variable rates, prepayment penalties, inclusion of leasing transactions and responsibility of the lender in campaign sales. (Capital Market Board, 2005)

In the draft law, housing loans provided by mortgage finance are differentiated and regulated separately from other types of consumer credits and the restrictions on variable rates are abolished for these kinds of loans and prepayment penalty for fixed rate loans is introduced.

In the draft law the primary lenders are allowed to give loans at variable rates beside fixed rate loans. However for the protection of the borrower, it is required that the lender must determine the upper limit of the variable rates or payments[38] and inform the consumer by stating maximum amount of monthly instalments he/she will encounter if the index rises to the upper limit in the contract. The reason behind this regulation is providing the consumer to foresee the worst scenario and measure the risks that are undertaken. (Capital Market Board , 2005)

[38] Central Bank of Republic of Turkey is designated to determine the indexes that will be used for the variable interest rates and payments.

The draft law also permits to charge prepayment fee to the consumers in case of the fixed rate credit agreements. Prepayment fee will not be applied to the variable rate credits. The prepayment fee up to 2 percent of the outstanding balance for fixed rate mortgages may be charged. The rationale behind this regulation is;

> With fixed rate or payment agreements, the consumers can make a profit by ending their current agreements and ending up with new agreements according to the developments in the market. This profit of the consumer is a loss for the financing institution in return, so a prepayment fee will be a tool to balance the loss and the profit of the parties (Capital Market Board, 2005).

According to the interviewee from bank B;

> "The availability of variable interest rates and prepayment penalty for fixed rate loans will create an important advantage for banks….. However, we think that 2 percent the prepayment penalty is not sufficient for the lenders. When we look at other examples abroad, we see that either each bank determines its own ratio or there exists much higher ratios than 2 percent for prepayment penalty."

The variable interest rates and prepayment penalty are controversial issues in the draft law. Although the availability of variable interest rate loans seems to be an advantage for the lenders for the achievement of the growth in housing loans, it is argued that it may lead to some disadvantages for the borrowers. One of the main issues in housing loans is the determination of monthly repayments which is directly related to the present income and expected income in the future, current macroeconomic conditions and expected conditions in the future and the current conditions and expected changes in housing sector. So, the changes in the expectations of due to external factors such as employment and inflation may lead to problem in the repayment of the debt. As it is known, before 2001 the variable rates were applied to housing loans and due to crisis it was prohibited in order to protect the borrower since the default rates were rapidly increased in high rates.

Additionally, although the fixed rate interest rate loans will be available according to the draft law, it is possible for the lender institutions not to lend in fixed rates and force borrowers for variable rate loans in order to transfer the interest rate risk to them.

This issue is discussed with the interviewee from SPK and he claims that;

> "…The borrowers may be disappointed or damaged especially the ones who borrow with variable interest rates if the interest rates do not change with indexes convenient to themselves….A civil servant for instance may encounter with an unpleasant surprise if he borrows loan indexed to CPI. …The General Directorate of Consumer Protection alleged this. They said that 'if you permit this [variable interest rates] they [banks] will close other loans [with fixed rates] or they increase the fixed interest rates to an extent that everyone has to borrow with variable rates. We don't believe this. We will see altogether. But there is an intense competition. Neither of the banks wants to reject their customers who demand to borrow with fixed rates. So he can not say 'let's abolish fixed rate loans or increase rates so [borrower] has to borrow with variable rates'. If the man can not borrow loan with fixed rates from your bank, the alternative is not borrowing variable rate loans from you. The alternative is borrowing from other bank with fixed rates…..There is a competition in banking. This year the banks decreased interest rates to 0,99 percent despite losses. They never thought of acting together. So I don't expect such a danger [acting together in order to establish a cartel in interest rates]. Especially if the consumer finance companies enter the market. None of them will say I will not give fixed rate loans, I will settle my business with variable rates. They will do their best in order to satisfy what the customer wants."

Consumer Protection Law regulates the defective goods issue in article 4. An article is added to Consumer Protection Law, in which the loan lending institutions become equally responsible with the building developer for product deficiencies in campaign product sales which are associated with certain building projects up to the credit amount for one year. It is stated in the rationale of the draft law that limitation of responsibility to the credit amount is "to foster the supply side of the houses, while the amount of the authorized houses to be used as collateral by the housing finance system is quite low." (Capital Market Board,

2005) The lender will also be responsible for non-delivery, incomplete delivery and late key delivery of houses with the building developer.

This is one of the most disputable regulations in the draft law that the lender is equally responsible with the building developer for product deficiencies (limited to one year) and non delivery or late key delivery in campaign product sales which are associated with certain building projects up to the credit amount. On the one side, it is argued that the responsibility of lender with the builder in campaign product sales will discourage the cooperation of lender and builder and this will affect the willingness of the credit lender negatively in order to be exonerated from liability as the lenders deal with some other commercial risks and thus, the responsibility of the lender should be diminished. On the other side, it is argued that one year responsibility of credit lender is in contradiction with the consumer protection law and Law of Obligations in which the period is 5 years, thus the period of responsibility of lender should be increased to 5 years in order to protect the borrower.

New rules on pre-contractual information that must be provided to the customers by lenders at least one day before the contract signing are also added to the Consumer Protection Law by the draft.

It is mainly argued that foreclosure and bankruptcy law is one of the biggest impediments towards a well-established and reliable housing finance system since foreclosure process is very long compared to the countries that have well developed housing finance systems. In Turkey a foreclosure process may last for 2-3 years.

Foreclosure and Bankruptcy Law "has various clauses to protect the rights of the debtor and to ensure that the property is liquidated at a fair price."(Capital Market Board, 2005) However, there are arguments that these clauses may be misused by the debtors to slow down the foreclosure process by using their rights to make objections and challenges. Indeed, the past experiences has showed that as the high inflation rates diminishes the real value of the debt and increases the value of the dwelling unit, delaying foreclosure process becomes an advantage for the debtor.

The draft law with the amendments in Foreclosure and Bankruptcy Law aims to shorten the foreclosure process and prevent the misuse of certain rights by the debtors in case of a default in the repayment of mortgage loan. In the draft law, "it is proposed to increase the amount of deposit needed to suspend foreclosure and to increase the penalty to prevent misuse of the right to demand the cancellation of the tender." (Capital Market Board, 2005) In other words, besides limiting the time to post objections by the delinquent, the deposits needed for placing the objection are also increased by the draft law. According to the draft law, misuse of the right of requesting annulment of a legal tender is tried to be prevented by the increased fines applied. Moreover, the deposit ratio needed to stop the sale is also increased with similar intentions. The looser of the case will pay all fees and expenses which means the objections for time gaining purposes will be costly for the delinquent borrower (Özsan and Karakaş, 2005b)

The interviewee from SPK states that,

> "There are amendments made in Foreclosure and Bankruptcy Law, three years ago there was no need for such a regulation because the file number under legal follow up per bank was one or two…. Now housing loans increased in quantity and volume, perhaps more loans will be legally followed up. Hereafter, banks will take into consideration the problems in foreclosure when they extent housing loans because previously loans were extended to only high income group in small numbers to selected people. They were not legally followed-up. Now, with the decrease in interest rates, middle income will demand housing loans; these amendments are made in order to prevent banks not to behave deliberately in lending to these groups saying that 'I may encounter with problems in the foreclosure processes"

According to the draft law it is stated that in the foreclosure of the mortgages the creditor can use distraint as well as the liquidation of the mortgage. By this regulation beside the way of liquidation of the mortgage, the way of distraint becomes available. However, it gives the opportunity to the lender that the both ways can be used at the same time for the same borrower.

In the draft law, it is proposed that only licensed appraisers be appointed to appraise the property in contrast to the existing foreclosure procedures in which any expert may be appointed by the foreclosure officer to appraise the property before the tender. However, due to the lack of enough number of licensed appraisers, this clause will become effective after a three year transition period for the development of the appraisal profession

In the draft law, there are amendments made in tax laws by which the transactions are exempted from stamp duties and any other type of transaction tax such as the banking resource utilization support fund, banking insurance and title registration fees. The incomes provided by housing finance capital market instruments such as mortgage backed securities and mortgage covered bonds and housing finance funds are to a large extent exempt from tax.

The aim is "to decrease the overall operational costs during the transfer of funds from capital markets to homebuyers." (Capital Market Board, 2005) With this regulation it is expected that the tax incentives will promote the mortgage system, and thus informal housing will decrease and housing standards will increase.

The tax issues in the draft law are also very controversial. The arguments such as tax incentives which are two sided as tax relieves for lenders and for borrowers will lead to decline in real estate tax returns are very much debated. Karakaş and Özsan (2005a) object this prevision stating that "tax incentives are crucial for fostering the lending activities of the banks and creating a demand for secondary market products." They remark that the increase in the number of transactions will provide an increase in tax returns and the tax incentives such as corporate tax incentives on mortgage covered bonds and mortgage backed securities' issuance and interest rate incomes will attract the investors which are necessary in order to succeed a well-developed secondary market.

It is also argued by the interviewees except the interviewee from SPK that income tax deduction of the interest of the monthly instalment is a very important and necessary subsidy to be undertaken by the government in order to increase the number of people benefiting from the institutional housing finance system. The interviewee from SPT objects this; stating that

> "This system must operate totally in market conditions. Tax relief for borrowers means lesser taxes will be paid to the state and it means state will subsidize the system with this relieves. At first, we included these relieves in the draft law, but we regret later. Ministry of Finance objects this issue and I think they are right."

When the borrowers profile is taken into consideration who are high income groups, income tax deduction can be regarded as subsidizing these high income groups However, it is thought that the income tax deduction of the interest of the monthly instalments should be included in the draft law with some criteria such as the deduction should be available only for the households who do not have any houses in order to prevent to subsidize the housing for investment to acquire rent. Also the limit of tax deduction should be arranged according to the house price not the credit amounts in order not to subsidize luxury houses for high income groups.

5.3.2. Establishment of Secondary Market: *Is a Remedy?*

In the draft law secondary market institutions and instrument are defined in detail as well as their functions and how will they operate. Before explaining the foreseen system in the secondary market, it is required to discuss the expectations regarding this regulation.

First of all, it is obvious that main reason for the establishment of a secondary market for housing loans is to increase the liquidity in the primary markets with the funds provided from capital markets. In other words, it is expected that with the integration of housing finance to capital markets, funds from capital market investors, especially foreign funds will be mobilized for the new housing loans. Secondly, it is expected to minimize the risks immanent to housing loans by issuing mortgage covered bonds and securitization through mortgage backed securities.

However, these are long term (or middle term from an optimistic point of view) expectations of the market actors, namely SPK, TOKİ and commercial banks. As it is stated by the interviewee from TOKİ;

> “There is a belief in the market that when the draft law is accepted in the parliament, the banks will begin to extend housing loans with lower interest rates and longer maturities. This will not happen immediately. The system needs to settle and operate. The necessary institutions for the secondary market will be established step by step… The establishment of system will take maybe 2-3 years maybe 5 years.”

It is also expected in the long run that secondary markets will force interest rates to decrease as a result of funds provided from capital markets. The interviewee from bank B claims that

> “Whether the cost of funds diminishes with the securitization, it will be reflected to the interest rates of housing loans. Indeed it was one of the aims of the draft law that to expand the housing loans to larger groups by decreasing interest rates with less costly funds from capital markets”

As it is stated in the beginning of this section the draft law tries to establish the regulations for the secondary market institutions and instruments. According to the draft law, “Mortgage Finance Corporations” (MFCs) are defined in Capital Markets Law as secondary market institutions which have two fields of activity:

1. operate as a conduit for the securitization of the receivables arising from housing finance,
2. provide liquidity facility to the primary lenders

Moreover, they can perform both functions at the same time. (Capital Market Board, 2005)

In the draft as a conduit MFCs “will be able to buy home loans from primary lenders, hold them in portfolio, sell them, issue covered bonds secured by the home loans in their portfolio, and also securitize these loans via housing finance funds”. (Capital Market Board, 2005)

As a liquidity facility, MFCs will provide loans to primary lenders secured by the housing loans of these lenders. In other words, MCFs are expected to extend credits to the banks or other lenders in order to raise funds which will be channelled for housing loan purposes.

Capital Market Board is given the authority to regulate the principles of establishment, basis of operation, licensing for the operation and obligations of MFCs in the draft law. Additionally, Banking Regulatory and Supervisory Authority will be the regulation and supervision authority for MFCs in cases that the owners of 51 percent of MCFs or institutions which control MFCs are subject to the regulation and supervision of this Authority

In the draft law, two types of new capital market instruments are defined namely covered bonds and mortgage backed securities to be issued by housing finance funds (Article 8 which amends the article 13/A of the Capital Market Law).

According to the draft law;

> Mortgage covered bonds are debt securities which are general obligations of the issuer and secured by assets in the cover pools. Mortgage covered bonds can be issued by banks and mortgage finance corporations defined in Article 39/A of this law. ...... Issuers are required to register the collateral assets, apart from their other assets, in a cover pool. (Capital Market Board, 2005).

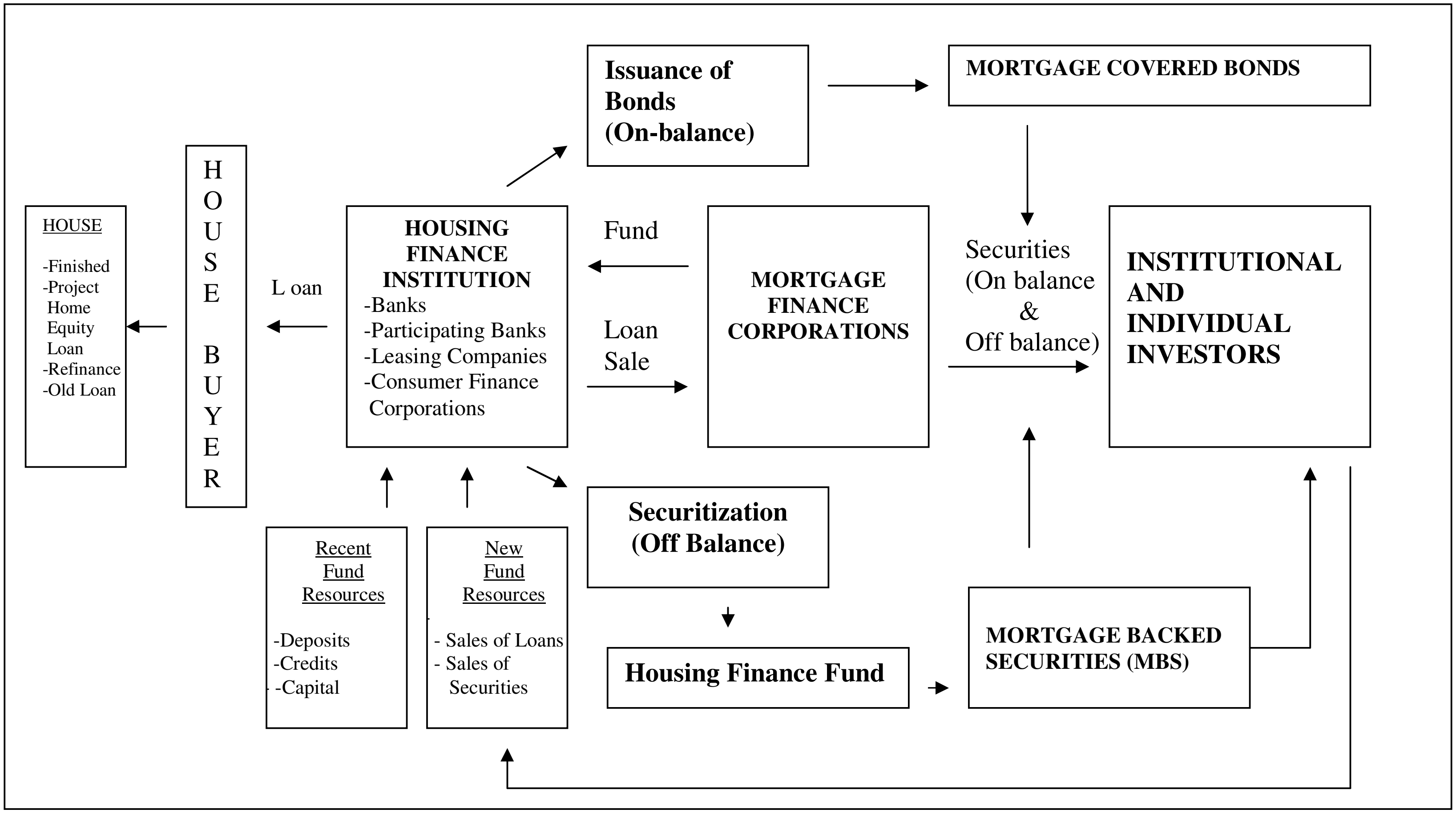
Covered bonds are on-balance sheet funding instruments. That is to say; the assets in the cover pool can not be used for any other purposes until the mortgage covered bonds are redeemed.

The draft law regulates the covered bonds in detail; identifies the matching principles between the cover pool and the bonds issued, and recognizes the penalties for the cover monitor, in case he/she fails to perform his/her responsibilities, who is authorized by the Board for monitoring and inspecting the cover pool.(Capital Market Board, 2005)

In the draft law housing finance funds which will be used to securitize the receivables, arising from housing finance are defined.

Mortgage backed securities, the securities whose cash flows are backed by the principal and interest payments of pooled housing loans, are also included in the draft law. These securities are suitable to be traded in the market and may be issued in terms and with coupons. As they are off-balance sheet funding instruments, they provide more liquidity. Additionally they are readily-marketable securities with a less cost of funding.

In the following, the secondary market circuit for housing finance according to the draft law is summarized in Figure 5.3.



Source: Dönmez, 2005

Figure 5.3. Housing Finance System in the Draft Law

5.4. Conclusion

The number and volume of housing loans have increased very rapidly in recent years due to the positive effects of decreasing inflation, capital inflow and decreasing interest rates in Turkey as almost the only way of institutional housing finance. However, they are far from being available for all in practice.

Housing loans extended by commercial banks are mainly demanded by high income groups since only this group can afford this 'costly' way of housing finance since the real interest rate of these loans are very high. The middle income groups can only afford these loans for small amounts whether most of the funds are accumulated or borrowed from non-institutional lenders such as relatives as down payment. In other words, borrowers either have to allocate large proportion of their income to monthly instalment payments of housing loans or have to accumulate large amount of down payments in order own a house. Moreover, the difficulties in proof of income and lack of job security in the private sector also limit the number of people who can access these housing loans. The low income level for a large segment of the population is another important factor that affects affordability of these loans. As a result it is explicit that housing loans are not affordable for low income groups and they have been underserved and have not been able to participate in the demand side of the housing finance market (Akçay, 2003)

From the lenders side, there exist many problems related to lending housing loans. First of all, the commercial banks, as the profit seeking institutions, lend housing loans in competitive market conditions and during the inappropriate economic conditions with high inflation, for instance in crisis period; they are reluctant for lending long term housing loans. Housing loans also compete with other risk-free profitable investment tools such as government debt financing. Moreover, the interest rates applied to housing loans increase to higher levels in these periods which eliminates the possibility of financing housing with housing loans.

Secondly, commercial banks' funding resources for housing loans are limited to deposits and foreign credits. Lack of secondary mortgage market for housing loans compels commercial banks to finance housing loans with their limited resources which impedes the availability and growth of housing loans.

Thirdly, housing loans provided by commercial banks are financed with short term deposits, lent in fixed interest rates which create some structural risks for the lenders. Commercial banks, in order to hedge with these risks either use derivative instruments in the financial markets which also create additional cost or lend these loans quite conservatively with high interest rates (currently 21 percent per annum) even in favourable economic conditions to higher income families with lower risk profiles.

In addition to these, housing loans are not steady and continuous way of housing finance in Turkey since they are given in market conditions open to the impacts of global economic and financial changes. Hence, discontinuous and cautious lending behaviour of commercial banks not only affects the borrower's demand on housing loans but also the supply of houses indirectly which is the most important determining factor of house prices; the other important component of affordability beside housing loans.

The draft law related to the housing which regulates the demand side of the housing issue. The rationale of this draft law is eliminating the legal obstacles related to housing loans for the lenders such as consumer protection issues, foreclosures, tax issues in order to promote primary markets and establish a secondary market circuit for housing finance in order to channel funds from capital market investors to housing loans through an integration of the housing finance to capital markets.

Although the draft law is not code law and a regulatory and supervisory institution assigned in the draft law does not exist, the interviewees of loan lenders, SPK and TOKI do not think that it may lead to difficulties in the implementation of provisions of the law and coordination of issues related to housing finance. The interviewee from SPK argues that

> "The issues amended in the draft law will be regulated and supervised by the related institutions since it is impossible to establish a regulatory and supervisory institution for housing finance. It is a multi-dimensional issue. Banks, for instance, are under the regulation and supervision of BDDK. Are we going to establish new banks for housing loans or does another institution regulate and supervise the only housing loans extended by banks? This is not possible. Every institution has the authority to regulate and supervise the issues related to its area"

In the draft law the primary loan lenders, the features of loans such as interest rate, prepayment fee for fixed rate loans and etc. are defined. The draft law regulates the issues for both the lender and borrower in the context of consumer protection and foreclosure process. The tax issues related to both primary and secondary market are also regulated by this draft law.

First of all, the housing loan lender institutions which are defined in the draft law are either bank or other financial companies which have other functions beside housing finance such as commercial banking, leasing or consumer finance. The fund resources of these institutions are naturally allocated to these functions beside housing loans. In other words, housing loans will compete with other lending activities which may be more profitable in some periods. This may lead to instability in loan lending in the primary market as well as the secondary market when the macro economic conditions change, for instance, since these institutions may be reluctant to give long term housing loans and channel their funds to other profitable areas.

Although it is stated by all interviewees that lack of specialised institutions will not affect the performance of the housing loans in the primary and secondary market and there are no obstacles for lender institutions to be specialised in housing loans, I think that lack of a specialized housing finance institution in the primary market will create an important deficiency in housing finance system since the strongly developed primary market is a must for an operating secondary market.

As it is stated before, the volume of housing loans is very low in Turkey. As integration of housing finance to capital markets is aimed in the draft law and the success of the secondary market conduit is directly related to the volume of the housing loans to be securitized in this market, the inclusion of TOKI's receivables portfolio to the housing finance system will provide a good starting point for the secondary market transactions in order to increase the liquidity in housing finance.

It is also pronounced by the interviewee from TOKİ

> "The portfolio of the outstanding receivables of TOKİ is very important and amounts nearly 4 million YTL in total. At first, TOKİ was excluded from the system. We thought that if there will be securitization this portfolio should be included in the system. During the meeting of Planning and Budget Commission we achieved to include this portfolio in the draft law. I think we are right. … Both the magnitude of our portfolio and our securities for this portfolio are very important… Since we don't give the title until the debt is repaid. This makes our securities powerful. I mean our willingness to include our receivables to the system depends not only on the magnitude but the technical powerful features of our portfolio. We think that our receivables portfolio is very valuable. I don't know, they [should] think (laughing)"

According to the draft law, the role of public is very limited in both primary and secondary markets of housing loans. It seems that the housing finance system is totally left to the initiative of market mechanism. Since, the interviewees think that the resources for this system will be provided through market mechanism.

They do not expect any resource transfer from the public. The interviewee from SPK explains this issue as,

> "Except the income tax deduction which probably will not be included to the law, the state will not allocate any resources to housing finance system foreseen by the draft law. The allocated resources will be totally channelled funds from savers and the investors through capital markets within the market mechanism. The address of the resources will be either London or New York (laughing)"

By this draft law, every income groups will not be included in the housing finance system. The low income groups will be totally out of the system. Middle income groups will be able to benefit from the system in the long run. The common opinion of the interviewees is that state should find solutions for the housing problems of these groups with either through direct financial subsidies which target these groups or directly involve in housing market such as supplying housing for them. TOKİ's social housing projects are highly appreciated in this context. At the local level, it is thought by the interviewees that municipalities should focus on housing projects for excluded groups from the housing finance system.

Although the supply side of housing is not the subject of this draft law it is stated by all interviewees that the lack of housing supply will lead to problems in terms of affordability of housing. Since, one of the most important problems regarding to housing is housing shortage which means supply of houses convenient to be credited within the institutional housing finance system is not sufficient in Turkey which leads to increases in housing prices and decrease the affordability of housing for households., it is thought that the policies regarding the housing supply should be implemented in order to increase the qualified and affordable housing.

The draft law is waiting to be discussed and approved in the general assembly of the parliament. Although it is thought that current macro economic conditions are convenient for the passage of the draft, the interviewees claim many reasons for the pending draft law as; political ambiguity due to the forthcoming elections, the tension with the European Union, lack of agreement among the institutions in certain issues such as consumer protection and tax relieves, the delay of government just before the elections in order to increase the public support and the possibility of IMF's lobby which is against for such a regulation.

The last and the most important issue related to draft law in particular, housing finance in general is existence of convenient macro economic and political conditions. It is obvious that external factors such as macroeconomic conditions, global capital movements, housing policies affect the achievement of the housing finance system. Currently, relatively better macro economic environment is achieved (low inflation, lower interest rates etc.), capital inflows exist and the economy grows. It is crucial to understand that the economies that grow with foreign capital inflows may experience the reverse.

So this risk threatens whole financial system and economy. There are examples in other countries such as Brazil, Colombia and Thailand that the housing finance systems have partially collapsed in the reverse case. The starting point in these countries have been the capital outflow since these economies are fragile and open to the negative effects of capital outflows. First of all, interest rates will increase, many borrowers may loose their jobs and can not repay their loans, the banks in order to cover their losses sell the houses collateral of loans but due to oversupply the prices fall enormously, neither the banks nor the borrowers can cover their losses with the sale of houses. The banks may go bankrupt. In short the overall economy may damage from such a crisis. The interviewee from SPK claims that

> "the new regulations in Turkish housing finance system neither damage the economic stability nor establish it. Housing finance system can be affected from macro economic stability but can not affect the stability in a negative or positive way. When we think the relationship between them; the economic conditions are independent variables and housing finance is dependent variable."

However, it is argued by Akışık (2005) that the crisis periods have lasted relatively short in Turkey compared to other developing countries since the household have not been indebted for long terms and lack of long term loans became an advantage for the rapid recovery of the economy.

CHAPTER 6

CONCLUSION

This thesis aims the evaluation of the role of housing loans extended by commercial banks on housing finance in Turkey and assessment of the prospective legal regulation namely the draft law in terms of lenders and borrowers beside the discussions of the anticipated impacts of this housing finance scheme to the commercial banks, the housing loans and borrowers within the context of global trends in housing finance.

Housing finance systems differ across the countries. The housing finance of a country is shaped in accordance with the conditions of that country such as political, social and economic policies, laws and regulations related to housing, financial infrastructure as well as other factors like urbanization level, population growth, and economic development level. Although housing finance system of each country had evolved in accordance with the changes in political, social and economic policies, and legal regulations during their life-span, the beginning of 1980s was a milestone for the radical transformations in the housing finance systems in many countries.

Until 1980s, the housing finance systems of most countries were based on special circuits in which the mortgage lenders were specialized housing finance institutions operating in a protected environment with some restrictions and privileges. Although, the resources of funds for mortgage loans (deposit taking, capital market or contract savings), market structure of these institutions (state-owned, cartel, government supported), regulation of these institutions and subsidies differ, their primary function was lending long-term mortgage loans with a rationale that private markets were incapable of allocating sufficient funds to meet demand at a “reasonable” price (Diamond and Lea, 1992). With these institutions, it was aimed to channelize funds to housing with government subsidies of which type and size were changing from country to country. The housing finance system and the rest of financial system of the country were generally segregated in order to protect these special housing finance circuits from macroeconomic instabilities. Mortgage loans extended by the specialized housing finance institutions were below-market interest rates as a result of their privileges in the funding sources and interest rate subsidies. Indeed, housing finance was a national issue to be dealt with the national resources unresponsive of macroeconomic conditions and financial markets.

During 1980s, varying in timing and magnitude, housing finance systems in most countries had encountered with transformations as a result of their economic and financial deregulation policies of the governments in power under the pressure of increasing inflation, interest rate volatility and competition, in addition to technological progress especially in communication systems. Housing finance has become more market-based with some policies such as eliminating the privileges of specialized housing finance institutions in providing funding resources, creating competitive environment with commercial banks in mortgage loans, determining the interest rates of mortgage loans responsive to market rates. In addition to these, integration of national capital markets as a result of free movement of capital has sensitized the housing finance to capital markets conditions.

Under the effects of these transformations, the institutions, fund resources, type of subsidies in housing finance system began to change which may be stated as global trends in housing finance. First of all, special housing finance circuits have begun to decline since “the evolution in capital markets has eroded both the reasons for having special circuits and the ability to maintain them.” These special circuits were “replaced with a more market based allocation of credit to housing”, reduced in importance or eliminated (Diamond and Lea, 1992:748). Secondly, competition and innovations in term of mortgage loans among banking institutions and mortgage finance companies have grown. Commercial banks have become the main lenders of mortgage loans in almost all countries. Thirdly, the housing finance has integrated to capital markets through the development of secondary mortgage market facilities (Renaud, 1999). Fourthly, various financial services has been developed such as appraisers, mortgage insurance services, improved property registration systems and etc. required for the development of mortgage markets both at the primary and at the secondary market levels (Renaud, 1999). Finally the policies of subsidies have drastically changed from general subsidies (subsidies for houses) to individual subsidies (subsidies for individuals) which are out of concern in this thesis.

The impacts of these global trends also differ across the countries in accordance with their development level. In developed countries macro economic conditions are relatively stable with low inflation level and with low volatility in interest rates, income per capita is high, social security facilities are improved with low unemployment rates, the urbanization is completed, population growth is very low and housing in terms of quantity is sufficient for the existing population. These conditions provide a better infrastructure for mortgage loans in particular and housing finance in general. However, in developing countries almost all these issues are reverse which complicate the housing finance issue and preclude the lending of mortgage loans.

As it is reviewed in chapter 3, mortgage loans, lenders of these loans and the organization of housing finance markets of both developed and developing countries have been affected from global trends in housing finance. First of all, the decline of the special housing finance circuits can be observed in all countries analysed in this thesis regardless of their development level. In these countries, the specialized savings institutions (building societies in the UK, thrifts in the USA, savings and loan institutions in Brazil, CAVs in Colombia) as the primary mortgage loan lenders lost their privileged status by the elimination of both tax advantages and restrictions for other financial institutions in mortgage lending that led to competition for both deposit taking and mortgage lending. Most of these institutions have converted to commercial banks which have become the main mortgage lenders recently.

As the housing finance systems became more responsive to market conditions, the inflation and volatile interest rates, the risks inherent to funding long term mortgages with short term deposits such as maturity risk and interest rate risk have become apparent. In order to grapple such risks and achieve risk management, housing finance has integrated to capital markets through secondary mortgage markets in these countries. Although in the USA unlike the other countries, secondary mortgage market were already operating with the foundation of secondary market circuits in order to minimize these risks, to increase liquidity and encourage the growth of nondepository lenders, the secondary mortgage market has enormously increased in volume by the 1980s. The integration of the UK housing finance system to capital markets has been rather slow due to the feature of mortgage loans extended in variable interest rates which transfer these risks to the borrower. Brazil and Colombia as developing countries have been trying to integrate their housing finance systems to capital markets in order to minimize the above mentioned risks and increase liquidity. But, initially, these countries have passed laws related to housing finance in order to constitute the legal and institutional framework for secondary mortgage market circuits such as securitization companies, foreclosure process, mortgage insurance and appraisal services etc. Colombia, compared to Brazil performed better in the integration period since 30 percent of mortgage loans are securitized and traded in the capital market.

However, in developing countries unlike the developed ones, due to the factors stated above such as unstable macro economic conditions, low income per capita level; the volume of mortgage loans are small, the capital markets of them are shallow, their economic and financial structures are fragile and open to external shocks. The main reasons for Brazil's failure in secondary mortgage markets for instance, have been the Southeast Asia and Russian crisis, and devaluation of real. Although, the economic indicators such as inflation, interest rates have been decreasing, economies of the most countries have been growing which have created better environment for long term lending for the last five years all over the world, this optimistic picture is totally related to the oversupplied money that is freely flowing among countries which is called as "hot money" threatening the macro economic stability of the developing countries like Colombia, Brazil and Turkey.

While these transformations in housing loans and housing finance have been experienced in most countries in the world, what was the situation in our country related to housing finance? What are the reflections of global trends in Turkey? Do the housing loans provided by commercial banks have major role in housing finance? The answer of these questions are tried to be given in thesis by the evaluation of past housing finance experiences, current situation in housing finance and housing loans, and the potential results of the anticipated regulations related to housing loans and housing finance.

Turkish past housing finance experiences which are reviewed in chapter 4 evinces that Turkey lacked special housing finance circuits contrary to the countries analysed in chapter 3. On the other hand, the housing loan lending policies were very similar to other countries on some aspects until 1980s. First of all, the primary housing loan lenders were Emlak Bank, a specialized housing finance institution and social security institutions which were assigned to give housing loans with their foundation laws in our country. These institutions were extending housing loans up to 15-20 years with interest rates irrespective of inflation which connoted the interest rate subsidies. However, the volume and number of these loans were very low. In this period, commercial banks, except Emlak Bank, Vakifbank and T. Ogretmenler Bank were prohibited to extend housing loans. It is obvious that the restrictions and privileges related to housing finance were parallel with the policies in other countries.

As it is known, the economic crisis through 1970s in the world had also affected Turkish economy and an economic stabilization program was put into practice in Turkey in 1980. With this program import substitution for industrialization approach was abandoned and liberalization of economy by reducing the role of the state was aimed, like the other countries. There were two important results of this program related to housing finance that were the increase of the interest rates granted by banks and bankers (private money dealers) for deposits over the inflation rate and the decrease in the real wages. The demand for housing in the beginning of 1980s had sharply decreased due to these results and housing sector went into financial crisis.

Although, the foundation of TOKİ in this period as a housing finance institution and developer can be regarded as the state's direct intervention to housing sector and housing finance which seems to be conflicting with the targets of the economic stabilization program, the main aim was the revitalization of construction as the locomotive sector for economic growth as it is discussed in the chapter 1. During 1980s, TOKİ has been the main housing loan lender beside Emlak Bank in a high inflationary environment. In this period different housing finance policies, applied in other countries, were adopted by these institutions such as contractual system or mandatory funds. In 1989, indexation of housing loans' interest rates like in Colombia and Brazil has started in order to create a market oriented housing finance system in Turkey in an inflationary environment as it is discussed in chapter 4.[39] However, the policies adopted from other countries by Emlak Bank and TOKİ in 1980s and 1990s have failed since they were short lived, because the governments in power applied inconsistent policies, the fund resources were not sufficient and macroeconomic conditions such as high inflation were not convenient for long term housing loans.

[39] See Fannie Mae, 1992 for further detail

Additionally, transfer of resources of TOKİ for housing loans to national budget since 1993 impeded the institution to function in housing finance. Besides, the other housing finance institution Emlak Bank was focused on commercial banking activities with an aim of making profit in 1990s rather than lending long term housing loans.

On the other hand, although the restrictions on commercial banks related to housing loans were abolished in 1979, it is rather difficult to mention their role in housing finance until 2000s since the loans extended by them were short term with low loan to value ratios and high interest rates due to the high inflation rates and the availability of investing in risk-free government bonds with high incomes.

The impacts of global trends in housing finance have become visible in 2000s in our country. First of all, Emlak Bank, which can be regarded as the unique specialised housing finance institution was decommissioned in 2001 by the government. As a result, the commercial banks have become the sole housing loan lenders in Turkey. Although the number and volume of the housing loans extended by commercial banks have increased since 2002 due to the better macroeconomic environment such as decreasing inflation, capital inflow and decreasing interest rates, they have been very small in volume compared to other countries.

In chapter 5 in accordance with the aim of this thesis, the role of housing loans provided by commercial banks as an instrument of housing finance is tried to be explored. From the borrowers' side, housing loans provided by commercial banks are affordable only for high income groups since they are quite costly due to high real interest rates and they are limited to people with lower risks. Additionally, borrowers face with problems such as support of income and job security during their access to housing loans. Moreover, borrowers either have to allocate large proportion of their income to monthly instalment payments of housing loans or have to accumulate large amount of down payments in order own a house with housing loans. Indeed, he borrowers' profile of housing loans extended by commercial banks can be stereotyped as the borrowers are middle aged, well educated men working as wage earner with high incomes.

From the lenders' side, there exist problems related to housing loans in term of resources of funds, allocation of funds and structural risks immanent to long term lending which negatively affects the housing loans. First of all, commercial banks' fund resources are not convenient for housing loans since these loans are financed with short term deposits, lent in fixed interest rates which create maturity mismatch for the banks in their balance sheets. Additionally, lack of secondary mortgage market for housing loans compels commercial banks to finance housing loans with their limited resources which impedes the growth of volume of housing loans. Secondly, commercial banks as the profit seeking institutions, lend housing loans in competitive market conditions and housing loans compete with other investment tools (e.g. government bonds) and business areas (e.g. commercial credits) in resource allocation. Thus, the banks allocate their fund resources to different fields in order to maximize their profit which decrease the supply of housing loans. Thirdly, the existence of structural risks immanent to long term lending such as credit risk, (amount of these loans are greater than other loans) maturity risk, (maturity is longer than other loans) interest rate risk (extended in fixed interest rates) and prepayment risk (creates difficulties in the management of cash flows for the banks) force commercial banks to lend conservatively with high interest rates (currently 21 percent per annum) even in favourable economic conditions and target high income families with lower risk profiles with low loan to value and payment to income ratios in order to hedge with these risks.

Although the banks try to minimize the risks they have undertaken with derivative instruments such as futures, options, forward, these instruments also increase the cost of funds for housing loans. The other way of hedging with these risks is increasing the capital of the bank which also creates additional cost of overcapitalization.

On the other hand, macro economic conditions such as inflation, interest rate volatility, unemployment, unequal distribution of income also affect both the supply and demand of housing loans in Turkey. As they are extended in market conditions open to the impacts of global economic and financial changes and shocks (e.g. foreign capital inflows and outflows), housing loans provided by commercial banks are not steady and continuous way of housing finance in Turkey. The supply of and demand for housing loans rapidly decrease in the worse macro economic conditions which also affect the housing sector as a whole.

Thus, the role of housing loans provided by commercial banks in housing finance is very limited in Turkey. Only high income groups can access to housing loans and lower-middle and low income groups are excluded from the institutional housing finance market.

As the housing finance with housing loans is very limited compared to other countries and is far from being remedy for housing finance problem in particular and housing problem in general, a draft law related to the housing finance is prepared and submitted to the parliament. The rationale of this draft law is the 'promotion of primary markets and lending conditions', the establishment of secondary market circuit for housing finance in order to channel funds from capital market investors to housing loans and the elimination of risks immanent to long term lending by commercial banks through the secondary market facilities

In the draft law, the primary loan lenders, the features of loans such as interest rate, prepayment fee for fixed rate loans, the secondary mortgage market regulation in terms of institutions and instruments of this market are defined. The draft law also regulates the issues for both the lender and borrower in the context of consumer protection and foreclosure process and tax issues related to both primary and secondary market.

However, as it is discussed in detail in chapter 5 this draft law have some deficiencies which may affect the performance of the system and impede the accomplishment of the aimed housing finance system. First of all, the lender institutions defined in the draft law are either banks or financial corporations which have other functions beside housing finance which means the current problem of resource allocation to housing loans will continue since housing loans will compete with other lending activities which may be more profitable. This may lead to instability in loan lending in the primary market as well as the secondary market when the macro economic conditions change since these institutions may be reluctant to give long term housing loans. Thus, lack of specialized housing finance institutions that supply housing loans continuously even in the worse macro economic conditions in the primary market will create an important deficiency in housing finance system since the strongly developed primary market is a must for an operating secondary market.

Secondly, as integration of housing finance to capital markets is aimed in the draft law and the success of the secondary market conduit is directly related to the volume of the housing loans to be securitized in this market, the inclusion of TOKI's receivables portfolio to the housing finance system carry great importance for the initial secondary market transactions in order to increase the liquidity in housing finance.

As a whole, it can be argued that housing finance market is totally left to the initiative of market conditions and open to the global shocks by this draft law. The role of public is very limited in both primary and secondary markets of housing loans in this scheme and the resources for this system will be provided through market mechanism. However, as Okpala (1994:1583) argues;

> in fact, even in the developed countries, the housing finance system or mortgage market is not left to operate entirely under unmitigated market situations and no system of housing finance in these countries is wholly unsubsidised.

One of the most important issues is that; the lower middle and low income groups are totally excluded from the housing finance system foreseen by this draft law. On the other hand, such a policy orientation is quite problematic and paradoxical in that; the housing problem in Turkey is most dramatically felt by the lower middle and low income groups. So, it is obvious that state would be given the duty for the solution of the housing problems of these groups either through direct financial subsidies which target these groups or with direct involvement of state in housing market such as supplying housing for them with public resources (Renaud, 1999). In the national level TOKİ's social housing projects are seen as solution in this context. At the local level, it is expected that municipalities would focus on housing projects for excluded groups from the housing finance system.

Middle income groups may be able to benefit from the mortgage system in the long run. Indeed, this implies another potential risk for the middle income groups that will be included in this system with the ideology of house ownership by 'loan repayment replaced with rent'. As it is discussed in chapter 5, with the draft law, interest rate risk would be transferred to the borrowers by variable interest rates and the possibility of loosing the purchased house due to shorter foreclosure would increase. In addition to these, the lack of information about this system would also lead to misunderstandings within these groups. Thus, these people may loose more than the loan amount such as the down payment they make due to the falls in house prices in the foreclosure process.

It is explicit that the secondary mortgage market would provide extra funding for housing loans from the capital markets, however, it is not the magical and unique way to achieve a comprehensive housing finance system. For the operation of secondary mortgage market a strong primary market for housing loans and a developed capital market is required.

However, the interviewee from SPK states,

> "Secondary market is not vital for a successful housing finance system. The housing finance system of the UK, for instance, depends heavily on deposits. Is it possible to say that the UK's system is unsuccesful? Of course not. The main point is minimizing the cost of funds either by deposits or secondary market. Colombia has securitized 30 percent of whole housing loan portfolio with high cost of funds. Well done! There is no success here. What are costs for the borrowers and lenders is the important issue. If you borrow with 10 percent and lend with 12 percent interest rates with a 2 percent cost of funds, this means you are very successful and do nothing for extra."

So, the creation of a well developed and stable primary mortgage market with sufficient funds to be allocated as housing loans to all income groups especially the needy ones must be given priority as it discussed by Okpala (1994:1585):

> In the current circumstances of developing countries, therefore, development of secondary mortgage markets may not realistically be a priority . Efforts should more usefully be directed at and intensified on strengthening the primary mortgage market and ironing out all the flaws in it before exploring the secondary mortgage market system. The eventual and ultimate development of the secondary mortgage market will benefit immensely from a strongly developed and established primary mortgage market.

Nevertheless, it is obvious that for an operating housing finance system both in the primary and secondary markets, stability in macro economic conditions is a must. Currently, relatively better macro economic environment is achieved (low inflation, lower interest rates etc.), capital inflows exist and the economy grows. Although it exceeds the aim of this thesis to discuss the solutions in order to minimize the macro economic instability, it is obvious that the basic paradox for developing countries is that; due to the lack of sufficient capital accumulation, foreign capital inflow is highly appreciated and the economic growth depends on these funds. However, since this foreign capital freely move around the world to make more profits, the stability provided by this capital may be damaged with the outflow of it.

The experiences of other countries such as Brazil, Colombia and Thailand show that the housing finance systems may highly affected from the instability in macro economic conditions with a starting point of the capital outflow since the economies of developing countries are fragile and open to the effects of capital movements. First of all, interest rates will increase; many borrowers may not able to repay their loans due to various reasons such as interest rate volatility in housing loans, job losses or income losses; the banks in order to cover their losses sell the houses which are collateral of loans but due to oversupply of housing on sale the house prices fall enormously; neither the banks nor the borrowers can cover their losses with the sale of these houses which is known as 'mortgage crisis' (Halisdemir, 2005). Perhaps the banks may go bankrupt in case of enormous increase in loan defaults and undermining risk management, etc. In short, the overall economy may be affected negatively from such instability.

To conclude, despite these risks, in order to establish strongly developed primary mortgage market and a comprehensive housing finance system, some policy measures should be taken in Turkey. In the following the policy proposal for sustainable housing finance system will be discussed.

- First of all, in the national level, it is the duty of governments to provide better macroeconomic conditions such as low and stable inflation and interest rates, low unemployment levels, equal distribution of income in order to guarantee the necessary environment for long term borrowing and lending for housing.

- As it has been experienced in the last two years, the increase in availability of housing loans with low interest rates lead to enormous increases in housing prices and decrease the affordability of housing with the housing loans provided by commercial banks. The policies regarding the housing supply should be implemented in order to increase the qualified (which does not mean luxury) and affordable housing such as production of land with infrastructure, direct involment of state in housing production via TOKİ in larger scales as well as local government involvement in the housing issue.

- The specialist housing finance institutions should be established to function in the primary mortgage market spread to whole country. However, it may be both very costly and time consuming to establish a new institution, instead, a state bank, may be given the duty of functioning as housing loan lender. On the other hand, the other functions of this bank such as commercial banking (lending commercial loans and consumer loans except housing loans) should be abolished in order to concentrate in housing finance. With the existence of specialised housing finance institutions it is aimed to take the advantage of operating in large scales which will ensure the continuity of lending activity even in worse macro economic conditions. This does not mean that commercial banks and other financial institutions will be prevented from lending housing loans. On the contrary, the main goal should be to enhance the primary mortgage market in Turkey.

- In order to increase the funds to be used in housing loans, fund resources such as contractual deposits of potential house buyers, compulsory savings of employees similar to FGTS in Brazil, unemployment insurance funds, the pension funds should be channelized to this bank as well as the funds provided by the securitization of loans in the secondary mortgage market. It is incisive that the yield of these funds should be in a level that attracts the depositors.

- The housing loan types that will be provided by this bank/institution should be diversified in order to attract the housing loan borrowers such as variable interest rate loans, balloon payment loans, price level indexed loans etc. These housing loans should be guaranteed with insurance fees added to the housing loans by another housing finance institution such as TOKİ for instance in order to increase the reliability of these housing loans for the secondary market purposes.

- One of the most important issues in housing finance is to establish a sustaining system which will not be affected from negative impacts of the macroeconomic changes. So it is crucial to lend housing loans with interest rates that ensures the sustainability of the housing finance system although they might not be given at the highest market rates.

- The secondary mortgage market institutions should also be established either owned publicly or privately in order to securitize housing loans provided by specialist housing finance institutions and commercial banks. These institutions should also guarantee the mortgage backed securities or covered bonds which are secondary market instruments.

As a conclusion, housing finance is a special issue that it can neither be totally left to the regulation of market nor of the state. It will be both well regulated and supervised in which public and private institutions can operate effectively in a sustainable system.

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