USAID Southeast Europe Financial Sector Conference: "Developing Secondary Mortgage Markets in Southeast Europe"

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I. Welcome

"Good Morning" and welcome to Sofia and this workshop on Developing Secondary Mortgage Markets in Southeast Europe. As Director of the Office of Economic Growth in USAID's Bureau for Europe and Eurasia, it is my pleasure and privilege to welcome each of you and to touch briefly on some of the important themes of the workshop.

Before I introduce those themes, I wish to thank the organizations and individuals who made this workshop possible. Let me begin by thanking the USAID Mission for hosting and supporting this event.

This workshop would not have been possible without the untiring efforts of USAID's housing finance partner, the Urban Institute and its local partner, the Institute for Market Economics (IME), Sofia. I want to thank Dr. Sally Merrill, Senior Associate, of the Urban Institute not only for her team's efforts but also for the assistance received from her IME colleagues in Sofia.

Additionally, I want to thank each of the members of our USAID Financial Sector Team. Several are with me here and you either have met them during last evening's reception or you will have the opportunity to converse with them over the next two days. In particular, Ms. Jean Lange, Senior Financial Sector Advisor, merits special recognition for her contribution to the development and success of this workshop. Please take advantage of the opportunity to speak with Jean and our USAID colleagues as time permits. We seek your ideas and want to carry your messages back to Washington with us. That is one of the important outcomes we expect.

Our agenda over the next two days has two characteristics that call for leadership: First, interesting topics always tend to fill more than the time allotted; Second, our agenda is packed with technical presentations and knowledgeable presenters. We need a leader to keep our discussions on track so that we do indeed move through the agenda in accordance with the schedule you have. Fortunately for us, Pamela Lamoreaux from the IFC has agreed to chair our workshop. Thank you Pamela for undertaking this responsibility – and good luck.

There is no stronger advocate for USAID support and technical assistance than our Ambassador to Bulgaria, The Honorable James Pardew. Though Ambassador Pardew had hoped to join us today, his presence was required elesewhere. We are fortunate, however, to have his representative with us, Roderick W. Moore, Deputy Chief of Mission, who will speak to us following Minister Velchev's remarks. Ambassador Pardew and Roderick Moore know from first hand experience the progress that Bulgaria has made on its journey to EU accession and integration into global markets. Moreover, they know full well that Bulgaria and its Southeast Europe neighbors seek and need continued and focused support from international donors as they endeavor to achieve greater and sustained economic growth, alleviation of poverty, conflict prevention, good governance, the rule of law, and social justice. Though we in this room know that housing finance has direct and indirect links to each of those goals, we need to carry this message beyond the confines of technical financial sector venues. Too many in government, business and civil society fail to appreciate the power and potential of housing finance and mortgage markets. So, my first request to each of you is that after this workshop ends we work together to carry its important messages and outcomes to a broader audience – one that includes decision-makers in government, business and civil society who are less versed in the importance of housing finance than we participants.

I also want to say that we are indeed fortunate to have with us this morning, the Finance Minister of Bulgaria, His Excellency Milan Velchev. Minister Velchev will speak to us immediately following my remarks. It is a pleasure for all of us to be here in Sofia. Bulgarian hospitality is well known beyond its borders and always remembered when we return to our homes.

II. Introduction to the Themes of the Conference

In these opening remarks, I will not delve into the depths of the technical themes of the workshop. The agenda you have outlines the contours of the components necessary for the development and growth of secondary mortgage markets. Each technical presentation will contribute to completion of a mosaic of housing finance that we can take back with us. We may not produce definitive answers to all of the questions and issues that may arise over the next two days, but that outcome is all right, because if we get before us all of the right questions, the answers will eventually follow – some here during the workshop and others following its close. Let's make sure our mosaic at the end of day two includes all of the right questions and guideposts that lead us to solutions. That outcome alone makes this workshop worthwhile.

This is a technical workshop:

- Over the next two days, we will ask how best to develop secondary mortgage markets – primarily mortgage bonds and mortgage backed securities -- in Southeast Europe.

- We are going to discuss concrete issues regarding primary mortgage market development and standardization relating to the legal framework, valuation, and mortgage default insurance.

- We are going to hear from representatives from three countries in Southeast Europe, Croatia, Romania and Bulgaria, where mortgage markets are expanding rapidly. There are lessons to be learned from their experience.

- As we move to secondary mortgage market development, our focus shifts first to global models. We then proceed directly to a detailed discussion of the different funding methodologies relevant to Southeast Europe, the buy-side perspective, and the numerous legal prerequisites.

- We are also going to hear some very interesting and relevant stories about primary and secondary mortgage market development from Poland and the Baltics – their problems and successes.

The agenda you have before you provides a more detailed roadmap so I will not repeat all of it here.

III. Prelude to the Technical Presentations: Four Questions

I would like to pose four questions for our consideration.

<u>First: Why Focus Now on Secondary Mortgage Markets?</u>

Why focus on secondary mortgage markets when the primary markets in some countries in Southeast Europe are still in their infancy. Are we premature?

As we consider our response, think about the following:

- **First**, secondary markets complement and support the development of primary markets. Putting in place the basic building blocks for secondary mortgage market development promotes better functioning and more efficient primary mortgage markets. Adoption of better mortgage-related laws, the standardization of mortgage policies, procedures and documentation, and the development of good data bases that are necessary for secondary market development will also spur the growth of the primary market.

- **Second**, experience shows that the development of secondary mortgage markets is the critical factor to catalyze greater standardization of laws, underwriting practices, and documentation not only within countries but also between countries. (In the U.S., the establishment of Fannie Mae and Freddie Mac spurred standardization and led to one of the deepest mortgage finance markets in the world.)

- A word about incentives: While everybody may tout the importance of standardization, until there is some real tangible benefit, – i.e., the ability to package and sell mortgage loans and free up capital for more lending –

banks and other stakeholders often lack the right incentives to bear the costs and demonstrate the discipline to standardize their operations.

- Next, a word about reasonable expectations and timeframes: Active secondary markets are not going to happen overnight. Given the focus on mortgage laws and regulations in the SEE countries right now, this is the time to push harmonization based on international standards within countries and between them. We should expect and work toward an evolution of secondary markets rather than a race for revolution of reform.

- A final reminder relevant to our first question: **<u>Changes in primary markets affect the development of secondary markets.</u>** As changes are being made to existing mortgage-related laws and implementing regulations and as new policies and legal and regulatory frameworks are being adopted to improve the primary mortgage market, it is essential that they be consistent with international standards and best practices in secondary mortgage market development. Upon conclusion of this workshop, the speakers, panelists and other participants in this room can help the private and public sectors in Southeast Europe appreciate and achieve this essential result.

<u>Second: Why Focus Now on Mobilizing Domestic Resources?</u>

The second question is related to our first. As we ask and answer, "Why Focus Now on Secondary Mortgage Markets?", we should be prepared to further discuss, **"Why Focus Now on Mobilizing Domestic Resources?"**

- Just five years ago a workshop on secondary mortgage market development in Southeast Europe (or for that matter, primary mortgage market development), would probably have been considered untimely at best and a misallocation of resources at worse. What has changed in Southeast Europe?

- The fact that we are having this workshop to discuss the nuts and bolts of mortgage finance and development of mortgage bonds and mortgage backed securities reflects the very positive economic developments over the last few years in this region —macroeconomic stability, declining inflation and growing incomes, combined with progress made in legal reform, pension reform and the establishment of a sound, growing and liquid banking system looking for good lending opportunities.

- Confidence has returned to most banking systems in SEE. Deposit growth has been strong as households are putting their savings into banks. And banks need to find good lending opportunities with the appropriate risk/reward trade-off. Mortgage finance is filling that bill in several of the SEE countries.

- Likewise, successful pension reform in the region is creating demand for a domestic supply of financial products with the appropriate risk profile to satisfy the demand of pension funds and their rapidly growing pools of money that need to be invested prudently. Currently there just is not enough product available in local markets other than government securities. Mortgage bonds and mortgage-backed securities can help meet this demand and provide a good risk-weighted safe return.

- Here are a few numbers indicative of the magnitude of the demand and potential: Outstanding mortgages represent on average about 38 percent of GDP in the EU. In Southeast Europe, that would represent a US $36 billion market. Today, in Poland, Hungary and the Czech Republic, mortgage markets are only between 5 and 10 percent of GDP. A similar rate in Southeast Europe represents a mortgage market valued between US $5 and $10 billion.

- In addition to size of the market, diversification of investment opportunities is important. It will be truly unfortunate if the pensions savings of, for example, Bulgarians or Croatians (who have moved most quickly to institute pension reform), must of necessity be invested **exclusively** in Western Europe to guarantee an adequate safe return instead of supporting the domestic economies of Southeast Europe. Markets in Southeast Europe need and require **new** products that represent **new** opportunities for prudent managers.

- It is truly good news that we can finally talk realistically about secondary mortgage markets in Southeast Europe and the issuance of a new type of asset class fueled by domestic pension resources. The ability to tap growing domestic resources decreases the dependence of Southeast Europe on official and foreign financial flows and is good indicator that foreign investors will also be attracted to the market.

Third: Is There a Case to Be Made Now for a Regional Approach to Mortgage Finance?

If we persuade others that it is time to focus our efforts on the development of secondary mortgage markets and mobilization of domestic resources, then is there a case to be made that international donors and the countries of the region should work together regionally? That is our third question. Put another way, "What does a regional approach to secondary market development offer over a series of country by country initiatives?"

- On a broad level, countries of this region working together, as natural economic partners, may be able to achieve faster progress towards EU integration with European and global financial systems.

- A more integrated, rather than fragmented, financial sector market in Southeast Europe will surely increase the attractiveness of both the individual countries and the region to investors as is helps resolve challenges relating to scale and risk diversification issues.

- Countries in the region face common obstacles to developing their mortgage markets; the problems are not unique to one country. Interested parties in the region working together, sharing information and solutions, can overcome these problems more quickly leading to faster growing mortgage markets in each of the countries in the region.

- More specifically, regional harmonization of mortgage laws, underwriting practices and documentation based on international standards and best practices should accelerate the growth of mortgage finance in SEE.

- I do not want to give the impression that we will see overnight a regional Southeast mortgage market or a pan-Balkan mortgage bond issue. As I mentioned, this is an evolutionary process more than a revolutionary one. The market landscape will change over time, as the countries in the region develop their markets based on international standards and best practices. As change occurs, a mortgage bond issue packaged with mortgages from more than one country in the region is certainly a distinct possibility.

- To develop secondary markets, sufficient scale and liquidity are needed. Harmonization and standardization are especially critical to developing vibrant mortgage markets given the relative small size of most countries in SEE. Under these circumstances, it is in everyone's common interest to cooperate and collaborate regionally.

- There is an unifying message of importance to each country in the region: As you develop and refine your primary and secondary mortgage markets, work hard to ensure that your policies and laws are based on international standards and best practices so that your mortgage products mirror those of your neighbors.

- This approach reflects what is happening today in the EU where member states are trying to break down the myriad of little differences in law and practice that continue to present obstacles to creating a single capital market.

- Given that you are at the beginning of developing mortgage markets in Southeast Europe, you have a distinct advantage. You have the opportunity to avoid obstacles to growth and move immediately to standardized products and practices. By accomplishing that, you will attract many more investors both domestic and foreign.

As a donor answering this third question, we conclude that <u>now</u> is, indeed, an appropriate time to work with the countries of Southeast Europe and other donors **<u>on a regional basis</u>** to establish coordinated and consistent mortgage finance policies, legal and regulatory frameworks, practices and documentation harmonized with international standards.

<u>Fourth: Why Should the Private Sector Lead the Development of Housing Finance in Southeast Europe?</u>

Our fourth and final question is a provocative one for it suggests that the private sector – rather than governments in the region – should assume the predominant role in developing mortgage finance markets. It asks, **"Why should the private sector lead the development of housing finance in Southeast Europe?"**

- This workshop has a private sector focus for one overriding reason: The best way to accelerate mortgage finance in the region is through market-based solutions via the private sector. This not only includes various banking institutions – for example, universal, commercial and mortgage banks – but also bankers' associations, credit bureaus, valuation associations, and real estate personnel.

- This approach puts the burden on the private sector to be more actively engaged as individual firms and through associations to initiate and advocate for change. To the extent there are problems and obstacles in government policy and laws to the growth of mortgage finance, it is up to the private sector to take the initiative, speak with a strong and unified voice, and be part of the solution working with governments rather than waiting for governments to act and solve the problems.

- Governments, of course, play an important role. But governments <u>should not</u> be in the business of providing mortgages or subsidizing interest rates on housing finance. Competing with and crowding out the private sector will stunt the growth of private mortgage finance and distort the market. It is also very expensive.

- Rather than supplanting the private sector, governments can and should augment market-based solutions to housing finance. For example, in emerging markets and transition economies, governments – working in concert with private sector actors –can play a role through guarantees and other credit enhancements to share in some of the risk.

- More fundamentally, governments are first and foremost responsible for establishing and enforcing a transparent and predictable legal and regulatory environment that supports mortgage finance. Key to mortgage finance is a legal system which allows for and facilitates foreclosure and a wide spectrum of funding options through the capital market. On the regulatory side, apart from good prudential bank supervision and securities regulation, efficient well-functioning administrative systems dealing with titling and registration are essential.

To sum up, our fourth question contemplates that the private sector is the most appropriate one to assume the predominant role in housing finance in Southeast Europe with governments playing a critically important supporting role – one that augments rather than supplants market based solutions. As the world famous economist Mancur Olson observed, marketaugmenting governments are the most important feature for generating sustained growth.

IV. Concluding Remarks and Follow-Up Requests

Before introducing Minister Velchev, I would like to repeat two requests I have made this morning and add two more:

First, do remember than the outcomes of this workshop need to be communicated to a wider audience that extends beyond the confines of financial sector technical specialists. Donor assistance is a very limited resource and is demand driven. After you leave here, reach out to decision makers in government, business and civil society who have vested interests in promoting economic growth and alleviation of poverty in the region and tell them more about the role that housing finance has to play.

Second, speak to the USAID financial sector specialists here from Washington and our International Finance Institutions colleagues. Tell them about the constraints you face, the opportunities in your countries, the kinds of technical assistance needed, and your ideas. We want to return to Washington with practical perspectives and suggestions in addition to suitcases that contain fine Bulgarian wine and rakia.

Related to this second request is a third one. As you are listening to the speakers, please think about how to act on all the good ideas that will be put forward, how to build on them, so that we can turn good ideas into concrete action plans.

Finally, as a follow-on, USAID is interested in building on the momentum that this workshop will generate. Tell us if there is interest among the participants here,– banks, banker's associations, pension funds, think tanks, etc. – in putting together a regional network of interested parties to work on specific issues to promote secondary mortgage market development. We are interested in discussing how to support such a group to continue the dialogue.

Real progress has been made in getting mortgage finance off the ground in Southeast Europe. The next challenge is to ascend to the next stage where we unleash and leverage the power and potential of primary and secondary mortgage markets. It is at that stage we will see increased availability of finance for housing, lower interest rates, widespread home ownership, and the means for expanding access to credit. It will also act to create new jobs and reduce poverty.

Thank you for your kind attention.

Now, it is with great pleasure that I welcome our Finance Minister Velchev. Milen Velchev graduated in international relations from the University of National and World Economy in Sofia. He has a Masters Degrees in Business Management from the University of Rochester, New York and in Financial Engineering from the Technological Institute of Massachusetts, in Cambridge, Massachusetts.

He began his professional career for Ministry of Foreign Affairs at the United Nations. Minister Velchev worked for the investment bank, Merrill Lynch, in London offering debt management advice to the emerging market countries of Eastern Europe. As Finance Minister of Bulgaria, beginning in 2001, he put this experience to good use, putting in place a series of bond deals with in effect reduced Bulgaria's outstanding debt and debt service. After only one year in office, Mr. Velchev was named "Finance Minister of the Year," in 2002 by Euromoney, a well-deserved achievement.

Welcome Finance Minister Velchev.