Efficiency and Stability of Housing Finance Systems: A Comparison of the United Kingdom and the United States

Michael J. Lea
Cardiff Consulting Services

Abstract

The U.K. and U.S. housing finance systems are two of the world's most efficient. Yet both systems exhibited instability during the past decade, as reflected in high rates of individual borrower and lending institution default. The difficulties stemmed primarily from the combination of macroeconomic policy instability and preexisting housing or financial market constraints. In the United Kingdom, volatility in monetary and fiscal policy interacted with constraints on housing supply and tenure choice to produce a speculative boom and bust in house prices. In the United States, constraints on mortgage contracts led to the insolvency of specialized housing lenders when there was an abrupt change in monetary policy.

Three important lessons can be learned from these events. First, important linkages exist among housing markets, the housing finance system, and the broader economy. Second, although liberalization benefits the financial system, it can exacerbate preexisting market distortions. Finally, the benefits of geographic diversification for housing lenders and insurers are significant.

Introduction

Housing finance systems in a number of developed countries went through a sea change during the 1980s. The deregulation of financial systems and increased competition between financial institutions led to a significant increase in the efficiency with which mortgage markets deliver credit to home buyers. As a result of these changes, the relative cost of mortgage credit declined, the availability of funds improved, and the contract set available to consumers expanded.

In a recently completed study, Diamond and Lea (1992) analyzed the efficiency of housing finance arrangements in five developed countries: the United States, Denmark, France, Germany, and the United Kingdom. They concluded that the United Kingdom and the United States had the two most efficient housing finance systems, on the basis of a quantitative and qualitative analysis.
of mortgage credit provision. In the quantitative analysis, the average adjusted spread between the all-in cost of mortgage credit and the cost of government borrowing was lower in the United Kingdom than in the other four countries during the past 10 years. In the qualitative analysis, a number of indicators of efficiency in funding, risk allocation, and government subsidy provision were examined. The United Kingdom had fewer distortions than the other countries (as of 1991) and ranked first in four categories of analysis and second in the remaining two categories.1

The U.S. system is nearly as efficient. However, its depository institutions were not as efficient on an operating basis as their U.K. counterparts. More important, the efficiency of the U.S. system is achieved through extensive support by the government. The government plays a key role by providing default risk insurance through the Federal Housing Administration (FHA) and the Department of Veterans Affairs and guarantees for funds raised in the deposit and secondary mortgage markets. The potential for mispricing of these guarantees, along with the advantages they convey to various sectors of the market, currently create a degree of inefficiency.

There is a dark side to this story, however. Some countries that underwent financial liberalization during the 1980s also experienced significant volatility in house prices, mortgage default rates, and institutional performance. Nowhere was this more evident than in the United Kingdom and the United States. During the 1990s, the U.K. housing finance system has been under considerable stress. Real house prices have fallen significantly, mortgage arrears and possessions have risen to record levels, and building societies, specialized lenders, and mortgage insurers have reported record losses. Issuance of mortgage-backed securities has dried up, and many outstanding issues have been downgraded. Mortgage insurance prices have more than doubled, high loan-to-value (LTV) loans are virtually extinct, and lender holdings of repossessed properties are exerting a depressing influence on the property market. The distressed condition of the housing market and housing finance institutions reflects the nationwide (and Europe-wide) recession. The structure and performance of the housing market and the housing finance system have been widely cited as causal factors in the U.K. economy's woes (e.g., Economist 1992; Maclennan and Gibb 1992; Muellbauer 1990; Whitehead 1992).

1 The categories were funding, credit risk allocation, interest-rate-risk allocation, liquidity, operating costs, and subsidy costs.
The U.S. housing finance system was subjected to extraordinary stress in the early 1980s. Adherence to fixed-rate mortgage lending in a volatile interest rate environment effectively bankrupted a majority of housing finance lenders. Liberalization of the financial system did not save many of these institutions, and the decade culminated in extraordinarily high rates of failure among banks and savings and loans. The 1980s were characterized by volatile house prices in certain regions of the country and by aggressive risk taking. However, real house prices (on a nationwide basis) were more stable than in the United Kingdom, and lender and insurer losses from residential real estate in the recent recession were modest. For the most part, institutional failures were due to losses from investments other than residential real estate loans. The ultimate demise of many housing finance specialists had no significant effect on the pricing or availability of residential mortgage credit.

The experiences of these two countries on the road to liberalization of the housing finance system raise several interesting questions. First, does increased efficiency necessarily lead to increased instability, as reflected in higher individual and institutional default rates? Second, to what extent did particular institutional and regulatory arrangements ("stabilizers") in these two countries contribute to the stability or instability of their housing finance systems? Third, what lessons can be learned from these experiences?

The principal conclusion of the paper is that the difficulties experienced in these two housing finance systems stemmed primarily from the combination of macroeconomic policy instability and preexisting housing or financial market constraints. In the United Kingdom, volatility in monetary and fiscal policy interacted with constraints on housing supply and tenure choice to produce a speculative boom and bust in house prices. In the United States, constraints on mortgage contracts led to the bankruptcy of specialized housing lenders when there was an abrupt change in monetary policy. Institutional stabilizers may have reduced the incidence of failure. However, one stabilizer (deposit insurance in the United States) may have increased system instability.

Could the experience of the 1980s be repeated? The development of the secondary mortgage market and the introduction of adjustable-rate mortgages (ARMs) in the United States created a more efficient allocation of interest rate risk and reduced the likelihood of a repeat performance. In addition, the ability of U.S. lenders and insurers to geographically diversify minimizes
the impact of local or regional variability in house prices. In the United Kingdom, however, the underlying housing market conditions that produced the boom-and-bust cycle have not changed. Absent changes in the housing markets, mortgage lenders and insurers in the United Kingdom can reduce the potential negative effects of variation in house prices through diversification in the form of cross-border mortgage lending and insurance.

Relative performance

The housing finance systems of both countries began the 1980s with significant constraints on the supply of funds for owner-occupied housing.\(^2\) In both countries, non-price credit rationing may have moderated swings in housing demand but produced inefficient contract sets and credit allocation. During the 1980s, the governments of both countries pursued similar liberal economic policies that emphasized reduced tax rates, deregulation, and privatization. This strategy was particularly evident in the housing finance sector as interest rate controls (both implicit and explicit) were lifted, institutions were deregulated, and new contracts and competitive entities were introduced into the market.

Financial liberalization in both countries coincided with a prolonged period of strong economic growth (figure 1). However, both economies experienced a significant slowdown in the early 1990s.

The macroeconomic policies affecting the two economies were significantly different. In particular, the U.K. economy was characterized by higher and more volatile interest rates (figure 2). Short-term interest rates were cut significantly in late 1987 in the wake of the stock market crash. However, in mid-1988 short-term interest rates were raised from 7.5 to 15 percent in conjunction with the decision to bring the pound into the European exchange rate mechanism.

The U.K. mortgage market went through a period of relatively rapid deregulation in the mid-1980s, resulting in increased competition, expanded product offerings, and market pricing of mortgage credit. As a result, the mortgage rationing that characterized the 1970s and early 1980s came to an end. An

\(^2\) The states of these systems and the changes they underwent during the 1980s are described in detail in Diamond and Lea (1992).
increasingly elastic supply of funds to the housing market accentuated the effects of underlying demand changes. During the 1980s, housing demand in the United Kingdom increased, reflecting real income growth, increased household formation, and
privatization of a portion of the social housing stock. However, the near lack of a private rental market (which constitutes only 7 percent of the housing stock) constrained the tenure choices of households, forcing households into homeownership at a relatively early age. Land use regulations inhibited the production of owner-occupied housing at a time when the government was promoting owner occupation.

The confluence of these factors produced a sharp run-up of real house prices, which rose at annual rates of 6 to 17 percent between 1986 and 1989. The increase was fueled by a poorly timed tax law change in 1987 that accelerated home purchase decisions. Aggressive competition and relaxation of lending standards also facilitated home purchases and speculative investments. House price changes created powerful wealth effects that changed aggregate consumption and savings relationships. The increased liquidity of housing wealth was accompanied by a withdrawal of housing equity to fund consumption, driving the economic expansion of the late 1980s.

A contractionary monetary policy finally produced the desired result of slowing the housing market and the economy in 1990. Real house prices fell at annual rates of 7 and 8 percent during 1990 and 1991. The resultant volatility of the real mortgage rate for owner-occupied housing is depicted in figure 3. The high

*Figure 3. Pretax Real Mortgage Rate in the United Kingdom (Building Society Mortgage Interest Rate Less Annualized Year-over-Year Change in House Prices as a Measure of the Expected Inflation Rate)*
rates of expected house price inflation produced a sharply negative real mortgage rate in the late 1980s, but the steep increase in interest rates and the subsequent reduction in expected house price inflation created a high real user cost in the early 1990s. The decline of house prices has eroded consumer confidence and increased the severity of the economic downturn.

The recession and the decline in house prices have placed the housing finance system under stress. Mortgage arrears and possessions rose to record levels (with rates more than four times the average levels of the 1980s). It is estimated that 10 to 15 percent of mortgage borrowers in southern England had negative housing equity at the end of 1992 (Bank of England 1992b). The housing market continued to be depressed in 1992 with housing prices, number of transactions, and lending volume falling. Mortgage insurers reported record losses, most specialized lenders ceased new lending, and several troubled building societies have been merged with stronger ones.

Despite these problems, no major U.K. lenders or insurers have failed. Both types of institutions were well capitalized before the recession. U.K. insurers are diversified across product lines; property insurers are either composite or life providers. Regulators have moved aggressively to require mergers of weakened lending institutions (i.e., any institution that reports an annual loss). However, both lenders and insurers have large unrealized losses on their books. Many loans have been restructured, and lenders are allowing defaulted borrowers to remain in their houses until the housing market recovers, which in turn creates a perceived property overhang and depresses prices.

The housing finance system in the United States underwent extraordinary changes during the 1980s. At the beginning of the decade, it was in a state of near collapse. Thrift institutions experienced negative earnings and net worth as a result of the timing of asset and liability deregulation and the sharp rise in nominal interest rates. As is now well known, these problems reflected the almost exclusive reliance on the long-term fixed-rate mortgage funded by short-term deposits. Mortgage insurers also went through a troubled period. Several large insurers failed or were reorganized, victims of a relaxation of underwriting standards and a decline in regional property markets.3

The thrift crisis of the early 1980s led to a significant transformation in the U.S. housing finance system. The thrift industry

---

3 Unlike U.K. mortgage insurers, U.S. firms are monoline companies.
was deregulated, freeing institutions to invest in ARMs and diversify into other areas of lending and investment. Technological and regulatory changes fueled development of the conventional secondary mortgage market. A wide spread between mortgages and Treasury securities (in part due to the weak financial condition of the thrift industry after deregulation) spurred secondary market activities. In turn, the flow of funds into housing from a variety of sources offset the decline in importance of the thrifts.

*Figure 4. Pretax Real Mortgage Rates in the United States (Fixed-Rate Mortgage Interest Rate Less Annualized Year-over-Year Change in House Prices as a Measure of the Expected Inflation Rate)*

The real mortgage rate for owner-occupied housing in the United States was positive throughout the 1980s (figure 4). Nationally, U.S. interest rates and house prices were less volatile than those in the United Kingdom. Much of the decline in the mid-1980s reflected the fall in long-term interest rates.

**Does efficiency imply instability?**

The United Kingdom and the United States have evolved into two of the most open and competitive economies in the world. This development is particularly true in housing finance, where

---

4 Because the predominant U.S. mortgage rate is a longer term rate than that in the United Kingdom, there is less volatility in the series.
competition is fierce, market entry is easy, consumer choice sets are relatively complete, and costs are minimized. These factors lie behind the judgment that these two systems constitute the most efficient housing finance arrangements. However, both systems have exhibited significant instability in recent years: The U.K. system generated widespread individual failure, and the U.S. system generated widespread institutional failure.

In the United Kingdom, the primary factor in instability in the housing finance system appears to have been housing market constraints. Tenure constraints (the lack of a private rental market) and inelasticity in the housing supply (reflecting tight land use controls) led to the formation of a speculative bubble in house prices when the economy was subjected to the shock of financial system liberalization. As Muellbauer (1990, 5) notes, “not only did financial liberalisation help to drive up house prices but it made housing wealth more spendable than ever before. It was astonishingly foolhardy to liberalise finance and almost everything else in the economy while maintaining the key housing market distortions.”

The removal of supply constraints in one sector (housing finance) meant that the finance system became an effective transmitter of changes in behavior and policy, rather than an absorber of such changes. Before liberalization, there was considerable pent-up housing demand owing to the limited availability of funds. With liberalization the supply of funds became more elastic, accommodating the increase in housing demand in the mid-1980s. The lack of supply constraints (including realistic underwriting guidelines) in the finance sector effectively allowed more individuals to “go to the edge” with respect to housing purchases. Easing of monetary and fiscal policy in 1987 and 1988 contributed to the overheating of the sector and the economy. Real interest rates had to rise very high to cool the economy in the late 1980s, which effectively “killed” the housing market into the 1990s. Thus, the U.K. experience may be a classic demonstration of the theory of the second best. The removal of distortions in one sector of the economy may have temporarily reduced aggregate welfare.

Other explanations for the instability of the U.K. housing finance system have been offered. For example, Chinloy and Megbolugbe (1993) have cited the predominance of the reviewable-rate mortgage loan in the United Kingdom as a possible source of

---

5 Maclennan and Gibb (1992) suggest that the United Kingdom’s macroeconomic policy application was too abrupt and severe. They distinguish between a policy that “cools” the market and one that “kills” the market.
instability. This type of mortgage is an interest-only contract in which the rate can be adjusted by the lender at any time and which relies on a companion life insurance policy to pay off the principal. As such, it is not amortized, and it subjects the borrower to changes in short-term interest rates.\(^6\)

The underlying question is whether it is efficient for consumers to bear interest rate risk. The answer depends on the characteristics of the instrument (e.g., interest rate and payment change formulas), expectations about interest rates, income and mobility, and the relative risk aversion of borrowers and lenders (see Arvan and Brueckner 1986a, 1986b; Dokko and Edelstein 1991). Because borrower and lender utility functions are not identical, the ideal instrument is neither fixed nor variable rate. In an open and competitive market, borrowers and lenders will select an optimal instrument according to risk preferences and existing information. As long as a complete set of contracts exists and borrowers and lenders are unconstrained and possess full information, the resulting distribution of loan types will be efficient.

Even with an efficient contract set, the inability of borrowers or lenders to anticipate interest rate change can lead to ex post difficulty. In a variable-rate mortgage system, it is possible that increased payment burdens resulting from interest rate increases may induce arrears and possessions. However, most of the difficulties in the United Kingdom have come at a time when interest rates have been falling.\(^7\) Falling nominal house prices and high LTVs for recent buyers appear to be the major factors in the record levels of possessions.\(^8\)

\(^6\) Technically, these mortgages do incorporate a degree of equity build-up for the borrower, as the life insurance contract has a surrender value that increases over time. This form of equity increases at very modest rates in the early years of the mortgage contract life, as does amortization of 30-year mortgages in the United States. For example, during the average life of 5 years of a 30-year fixed-rate mortgage, the outstanding principal will have declined by only 4 percent.

\(^7\) A recent survey by the Council of Mortgage Lenders (1992) found unemployment and marital dissolution to be the most significant causes of arrears. Also, the building societies in the past have explicitly attempted to shield borrowers from some of the volatility in short-term rates, at the expense of depositors.

\(^8\) A recent study by the Bank of England (1992b) found equity to be a quantitatively more significant factor than payment burden in mortgage arrears and possessions. As Maclennan and Gibb (1992) note, the United Kingdom has experienced house price cycles in the past, but the post-1989 cycle was the first time in 25 years that nominal house prices fell.
A more fundamental question is why mortgage lenders and insurers made 95 to 100 percent LTV mortgage loans in the United Kingdom, particularly after the tightening of monetary policy in the second half of 1988. Overoptimistic expectations about house prices and intense competition for market share have been offered as explanations. Also, the lack of a private rental market combined with government exhortations to purchase may have contributed to a relaxed underwriting environment (i.e., underwriters may have believed that the government, by means of housing benefits, would bail out overextended households in the event of default).  

An agency problem in the allocation of mortgage credit risk may have been a factor in the slow adjustment of underwriting standards. The mortgage insurers (the risk bearers) apparently allowed lenders (their agents) to continue to write policies with coverage up to 100 percent LTV at unchanged prices well beyond the peak of the market. These policies were typically part of a package of insurance products (including endowment and contents policies) sold to the borrower at origination. Therefore, it is difficult to ascertain the fee charged for default risk on the mortgage contract. Further research into the fee-sharing and contractual arrangements between insurers and lenders is necessary to analyze risk allocation and pricing.

The U.K. system has recently shown self-correcting behavior. In particular, mortgage insurers have ceased to cover loans with LTVs above 95 percent and sharply reduced their coverage of those with LTVs above 90 percent. Mortgage guaranty prices have risen significantly and insurers have tightened their underwriting guidelines, eliminating status or limited documentation lending.

In the United States, the primary factor behind the widespread institution failure was the regulatory policy pursued in the 1960s and 1970s. The prohibition against ARMs had been criticized by banking system analysts since the 1960s; however,

---

9 To a limited extent, this has happened. In 1992, the government introduced a modest “mortgage rescue” scheme wherein it will purchase foreclosed houses from lenders and then subsidize the rent for displaced households (Wall Street Journal 1992).

10 Of course, the medicine that cures the disease sometimes kills the patient. The inability of borrowers to obtain high LTV loans may have reduced the ability of homeowners to move and reduce their level of housing consumption, prolonging the decline in house prices and worsening the possession problem. High insurance prices have led some lenders (e.g., Abbey National) to consider self-insurance.
it was not until deposit interest rates were deregulated in the early 1980s, at the peak of the interest rate cycle, that the severe asset-liability mismatch in thrift institutions was exposed. As a result, more than 80 percent of the thrift industry was insolvent in 1982. The policy of thrift forbearance, along with expanded powers and weak supervision of risk taking during the 1980s, exacerbated the weak financial condition of many thrifts, leading to their demise by the end of the decade.

Financial market liberalization has been linked to higher failure rates for deposit institutions in the 1980s and 1990s. However, evidence suggests that the vast majority of thrift institutions that failed in the early 1990s were insolvent in the early 1980s (see, e.g., Barth, Bartholomew, and Labich 1989). Ventures into other forms of lending and investment greatly increased the cost of the subsequent insured depositor payoff. However, most analysts agree that the insolvency of many of these institutions and the moral hazard problem of deposit insurance were the main causes of the debacle. There was increased risk taking in the residential mortgage market, including experiments with deeply discounted ARMs and limited-documentation, self-insured mortgages. The main losers from these activities appear to have been mortgage insurers, who may have suffered from agency problems similar to those of their U.K. counterparts. Although several firms suffered significant losses and ceased writing new business, subsequent tightening of underwriting stabilized the industry.

**Housing finance system stabilizers**

A by-product of efficient competitive systems is failure. In a recent speech, the deputy governor of the Bank of England noted, “Under increased competition the pressure of profitability leaves firms, and markets, less well protected against loss than they were, and results in a natural tendency for capital standards to be driven progressively lower” (Bank of England 1992a). In housing finance, this behavior includes relaxation of underwriting standards by lenders and insurers and greater interest rate and credit risk taking. The hallmark of an efficient system is the absence of regulatory constraints on behavior. The legacy of such a system is often higher failure rates among both households and institutions.

Failure has positive social effects. If a market economy is to function effectively, the threat of failure must be present to
control behavior. Failure also functions as a market signaling event, directing the allocation of scarce resources. But household and institutional failures also result in significant social costs. Homelessness is one manifestation of household failure. The loss of firm-specific human and institutional capital is a consequence of firm failure. Widespread individual household and firm failures can lead to system failure (as happened in the Great Depression).

To minimize the social costs of failure, governments regulate firm and individual behavior or create institutions that provide a safety net for certain groups. Thus, the tax-transfer systems in modern economies act as automatic stabilizers. Government influence over the allocation of credit has traditionally been justified in terms of broader economic goals, including macroeconomic stabilization. For example, the mortgage rationing systems that characterized the U.K. and U.S. housing finance systems in the 1970s were intended to moderate swings in housing demand.

The U.S. housing finance system has significant institutional stabilizers. Federal deposit insurance covers up to $100,000 per account and has allowed financial institutions to retain funds in local areas despite widespread institution failure. Federal mortgage insurance protects lending institutions from losses due to mortgage default. Government-sponsored enterprises (GSEs) provide liquidity to depositories that specialize in mortgage lending through collateralized borrowing (through the Federal Home Loan Banks) and mortgage sales (e.g., Fannie Mae and Freddie Mac). The loan purchases by the GSEs (along with FHA mortgage insurance) maintained credit to areas undergoing U.K.-style declines in house prices (e.g., Texas in the mid-1980s and New England in the late 1980s and early 1990s). However, government assistance to individuals is limited. Fewer than half of those eligible receive assistance, and lenders rarely forbear or restructure residential mortgages.

The secondary mortgage market acts as a stabilizer in the United States through the enforcement of underwriting standards. The GSEs publish, and continually revise, detailed underwriting guidelines governing the purchase of mortgages,

11 The alternative, of course, is the model of the former socialist economies, in which no firms or individuals failed but the entire system collapsed.

12 Lender options in this area are limited by securitization. Loans sold into the secondary mortgage market have to be repurchased by the lending institution, which thereby realizes a loss.
and they reserve, and exercise, the right to put mortgages back to sellers or transfer mortgage servicing. As a result, minimum standards are enforced nationwide. For the most part, LTVs in the United States never rose above 95 percent. The experiments with limited-documentation underwriting and lender self-insurance were brief, though painful. Regulatory guidelines reinforce prudent underwriting. To qualify for lower capital risk weight, mortgages with LTVs above 80 percent must carry mortgage insurance. The mortgage insurers, in turn, are informally regulated by the GSEs.

The U.S. experience demonstrates how erstwhile stabilizers can have a destabilizing influence. The preclusion of ARMs before the 1980s was defended as a stabilizing influence on the grounds that such instruments subjected consumers to interest rate risk. In turn, depository institutions had to be subjected to interest rate controls to prevent ruinous competition. When inflation was low and interest rates were stable, the housing finance system was relatively stable. However, these stabilizers created distortions that ultimately resulted in high institutional failure rates and enormous tax payer costs. The moral hazard problem of deposit insurance certainly exacerbated the commercial real estate cycle in the 1980s and has been linked to high real interest rates (see Hendershott and Kane 1992; Shoven, Smart, and Waldfogel 1992). The recession may have been prolonged by the tightening of regulatory oversight and the increase in capital requirements for depository institutions. Also, the activities of the GSEs have been alleged to undermine the viability of portfolio lenders (see Carron and Brumbaugh 1991).

The U.K. housing finance system also has stabilizing features. The housing benefit program has supported the rent payments of unemployed households, including many former owner-occupants. Mortgage lenders have engaged in forbearance on and restructuring of defaulted loans. Deposit insurance exists to maintain confidence in and prevent runs on banking institutions. These stabilizers, unlike those in the U.S. system, appear to create few distortions, perhaps because U.K. stabilizers function mainly on the demand side and do not materially affect the supply of funds to the mortgage market or their allocation. Only deposit insurance coverage affects the supply of funds, and it is limited to 75 percent of deposits up to £20,000 per depositor. The housing benefit program may create a degree of moral hazard, in that households can overextend themselves on home purchases, knowing their rents will be covered if their homes are repossessed.
A major stabilizing feature in the United States is the sheer size of the housing market. Geographic diversification imparts stability to the housing finance system if house price trends and economic conditions in different regions are uncorrelated or negatively correlated. Real house prices on a national basis were relatively stable during the 1980s (figure 5). However, individual regions displayed much greater volatility than the nation. The figure reflects the swing in the northeastern United States from very low house price appreciation in the early 1980s to double-digit increases in the mid-1980s to a decline by the end of the decade. House price changes in other regions substantially dampened the impact of the northeastern situation on the rest of the nation. The securitization process has allowed individual lenders to benefit from the nationwide diversification of the guarantor GSE.

The U.K. housing market also exhibited significant regional house price variability (figure 6). However, London and the southeastern portion of the country are dominant in terms of economic activity and popular perception. Also, the correlation between house price movements in different regions is much higher in the United Kingdom than in the United States, reducing the benefits of intracountry diversification. It is noteworthy that the evolution of house prices in London and the
As discussed in Diamond and Lea (1992), the United Kingdom is not the only country to display such instability in recent years. Denmark (with an exclusively fixed-rate mortgage environment) experienced a similar boom-and-bust cycle in owner-occupied house prices in the mid-1980s. Significant changes in tax and monetary policy, exacerbated by intense market share competition resulting in loosened underwriting, are the major causes of the cycle. Sweden and Finland have had similar experiences.

Lessons of housing finance liberalization

The benefits of an efficient housing finance system are many. After deregulation, the availability of funds is improved, and consumers benefit from an expanded range of contracts and features. Increased competition reduces the cost of credit to consumers, and market prices govern allocation of funds. Improved efficiency of the housing finance system in the United Kingdom and the United States was accompanied by increased volatility in house prices and in the performance of housing finance institutions. In one sense this result is not surprising. More open and competitive systems are more likely to take risks and thus to have higher rates of firm and individual failure than more regulated systems. However, closer inspection indicates

---

As discussed in Diamond and Lea (1992), the United Kingdom is not the only country to display such instability in recent years. Denmark (with an exclusively fixed-rate mortgage environment) experienced a similar boom-and-bust cycle in owner-occupied house prices in the mid-1980s. Significant changes in tax and monetary policy, exacerbated by intense market share competition resulting in loosened underwriting, are the major causes of the cycle. Sweden and Finland have had similar experiences.
that the primary causes of system distress in these two countries were preexisting housing or financial market conditions, not the process of liberalization.

In the United Kingdom, inelasticity in the housing supply and land markets and volatile monetary policy were the major causes of system distress. Extrapolative expectations on the part of homeowners created a speculative bubble that led to further price increases. Monetary and fiscal policy fueled growth in the bubble. Ultimately, a significant monetary contraction was needed to change expectations and cool the markets. The ease of obtaining credit through the liberalized housing finance system acted as a conduit of change between the housing sector and the wider economy.

Although the U.K. housing market is beginning to show signs of recovery, the factors that produced instability in the housing finance system remain. There have been no meaningful changes in the provision of private rental housing or the ability to supply new owner-occupied units in southern England. Furthermore, there are signs that inflation is returning in Britain and that many home buyers still view homeownership as a primary hedge against inflation (see Economist 1993). Although lenders and insurers have tightened underwriting guidelines, the incentive to relax these guidelines to increase market share remains.

In the United States, the thrift crisis appears to be in its last stages. More important, there is little evidence that the debacle could be repeated. The development of the secondary mortgage market, along with elimination of the prohibition against ARMs, has greatly improved the allocation of interest rate risk. Furthermore, regulators are on guard against interest-rate-risk taking, and capital requirements may soon be promulgated for interest-rate-risk exposure. However, the moral hazard potential of deposit insurance remains, though the risk is greatly reduced by increased capital requirements for depositories.

The United States also has the advantage of two important stabilizers that make a U.K.-style housing recession unlikely. Geographic diversification, particularly through the securitization activities of the GSEs, reduces the impact of regional downturns and the impact of local house price volatility on lending institutions and the wider economy. The application of uniform underwriting standards, both through regulation of depository institutions and through the policies of the
secondary mortgage market GSEs, moderates institutional and individual risk taking.\textsuperscript{14}

What are the lessons to be learned from the experiences of these two countries? First and foremost is the recognition of the linkages among housing markets, the housing finance system, and the broader economy. In particular, the increased liquefaction of housing wealth has important effects on savings and consumption that are not well understood. Second, policy makers must be aware of second-best situations when financial system liberalization occurs. Although liberalization imparts significant benefits to the financial system and the economy, it can exacerbate the effects of preexisting market distortions. Finally, the benefits of geographic diversification for housing lenders and insurers are significant. Although regions of the United States underwent boom-and-bust cycles similar to those of the United Kingdom, the impact on the housing finance system and the economy was largely offset by countervailing forces in other parts of the country. Thus, cross-border mortgage lending and insurance may provide significant benefits in Europe, particularly given the potential for a repeat of the 1980s experience.

\textit{Author}

Michael J. Lea is Principal at Cardiff Consulting Services, Cardiff, California, and Director of Research, International Union of Housing Finance Institutions. An earlier version of this paper was presented at the Conference on Lessons from the United Kingdom Housing Market Experience, Cambridge University, March 25–26, 1993. The comments of Mark Boléat, Christine Whitehead, and James Wilcox were helpful in the subsequent revision.

\textit{References}


\textsuperscript{14} As is true of any stabilizer, the costs can outweigh the benefits. The highly regulated German housing finance system has been very stable, but Germany has one of the lowest rates of homeownership among developed countries.


