Chapter 6

Consumer Information and Protection

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Protecting the consumer of housing finance products has become an increasingly important and debated subject in both developed and emerging markets. One of the special characteristics of housing finance urging intervention is the creation of large financial exposures for the consumer and a burden for him or her to make sizeable payments over extended periods, coupled with the risk of losing his or her primary residence posted as collateral. In addition to this "credit" dimension, housing finance contracts also contain many financial options for the consumer (for example, early repayment) and the lender (for example, assignment or sale of the loan, rate adjustment), whose values are extremely sensitive to a changing market environment and whose outcomes may impose additional risk on the consumer. For these reasons, the "why" of consumer protection is rarely debated today.

The specific goals and approaches of consumer protection are more contentious, however, because of inherent conflicts with other developmental goals. This is already noticeable in the traditional definition of the goal of consumer protection, because it ensures a "fair deal" for consumers while allowing lenders to reach a sufficient return on their invested capital. Seen from a broader financial-sector development perspective, consumer protection often means solving conflicts between market efficiency on the one hand, and market stability and social protection on the other. For instance, the right of a consumer to repay a fixed-rate loan unconditionally conflicts with the goal to offer the lowest-cost fixed-rate loan, because of reinvestment risk for the lender. On the other hand, the ability to afford by young households through credit products with low initial payments may conflict with stability goals when the same product entails a possible future payment shock. It is clear that finding the optimum here is a difficult task.

Considering the varying stages of housing finance development, there can also be no one-size-fits-all strategy of consumer protection. Roles and characteristics of the agents—lenders, developers, courts, local governments—that have to implement any set of rules change, and new agents (for example, brokers) appear. With this environment, the cost-benefit balance of individual rules changes, as do their implementation requirements and the availability of supportive social and economic policies. Finally, there is the risk that rules accumulate without regular review and cutbacks, leading to overregulation or inconsistent regulation.

This section starts by briefly referring to the different interpretations of the consumer that lead to different perspectives of the role of consumer protection, followed by a more precise economic definition of the objectives of consumer protection. The third subsection discusses the canon of the most common consumer protection rules in more detail: a frequently used classification follows the typical loan life cycle and distinguishes between consumer information rules, enabling transparency of loan offers and possibly advice to assist his or her choice, and "material" consumer protection rules governing limits to products and lender covenants, as well as the foreclosure process. The section then proceeds by discussing the costs of consumer protection, including the role of different delivery mechanisms, which can range from financial literacy programs over industry self-regulatory mechanisms to full legislative coverage. It is then asked whether consumer protection must not be seen as a luxury good for emerging markets, and if not, what options there are for economizing the discussed costs. The section ends with conclusions.

Defining the Consumer

Developed Markets

Modern consumer protection law in developed markets is based on two competing concepts of the consumer. The first is where the consumer is considered broadly rational and able to make informed decisions and choices in their own interest based on the information available to them. In this school of thought, it is deemed sufficient to protect the consumer by ensuring adequacy of information and antidiscrimination.[1] The second approach is much more recent and contends that some negative contract outcomes, especially if related to the most vulnerable in society, matter for society as a whole. Even if full transparency exists and contracts are negotiated fairly, the weight of negative individual outcomes may justify the costs of intervention into contractual freedom.[2]

The tendency has been for Anglo-Saxon countries to adhere to the former, and for continental European and socialist countries to adhere to the latter concept. The fault lines, however, generally go through individual societies, where they traditionally fuel debate between consumer and lender groups and liberal and conservative political camps. Intervention into contractual freedom—so-called "material" consumer protection—as a result has remained hotly contested. The consensus area is consumer information and empowerment in contract negotiations, which is seen as a necessary, although not sufficient, element of consumer law by both schools.

Emerging Markets

From a historical perspective, the transfer of law from Western and socialist country sources to emerging markets has led to a certain level of diffusion of these competing concepts worldwide.[3] For example, recipient countries

1. The Utilitarian school of thought has roots in the Age of Enlightenment and can be traced to Bentham (1789), who also wrote one of the first critiques of usury laws.
2. See Rawls 1971. Antecedents go back to the Greeks (Aristotle), the Christian canonic interest prohibition, and Marx.
3. This economic school was developed inter alia at the World Bank. See LaPorta, Lopez de Silanes, Shleifer, and Vishay 1998, and Djankov, La Porta, Lopez de Silanes, and Shleifer 2002

of Western law in Latin America, the Commonwealth, and parts of Asia can be shown to have adopted creditor- or borrower-friendly contract laws and judicial processes, depending on the origin of law.[4]

In addition, there has been increasing transfer of law between emerging markets. A prominent example is Islamic finance rules, which combine the religious and social perspectives of the consumer in their respective societies, justifying significant intervention into contractual freedom, including into the admissibility of charging interest. Formal Islamic finance rules, in their various forms today, span the entire Islamic world and, through the introduction of Islamic finance products for immigrants, have started to influence consumer-lender relations in Western Europe.

A specific problem of many emerging markets is the multiplicity of various layers of law implemented over time—for instance, today's set of consumer protection rules in Egypt are an amalgam of Western (French, British), Ottoman, socialist, and Islamic rules. Many countries struggle to create their own legal "identity" from their complicated legacy.

Consumer Protection Objectives

Two key objectives can be distinguished for an effective framework that consumer protection should aim to achieve.

The first is *improved efficiency* of the mortgage market, especially by addressing the market failures that lead to reduced levels of competition, high costs of loans, or the exclusion of consumers. The most important failures arise from information asymmetries between lenders and consumers; the heterogeneity of consumers with respect to their financial education, gender, race, and other factors; and transaction-cost asymmetries, which limit the ability of consumers to react to lender action; for example, to an interest rate increase.

The second goal is *market stability* and *social protection*: stability in the sense of avoiding over-indebtedness of borrowers, with its consequences

for key papers.

4. Djankov, La Porta, Lopez de Silanes, and Shleifer (2002) show, for example, that Latin American courts in their French law tradition have been more protective of rental tenants than their Asian and African counterparts, which were inspired by English law, but less so than courts in former socialist countries.

for the solvency of lenders and systemic risk for the financial sector. Social protection is relevant in the sense of mitigating individual hardship caused by mortgage market outcomes; for example, a personal insolvency or the loss of the most important pension asset of the consumer, his or her personal home, and, more broadly, the consumer's vulnerability to market shocks.

Information Asymmetry between Lenders and Consumers

The mortgage market is a "textbook case for market failure caused by information asymmetry. One party is in the market continuously, the other very infrequently—sometimes only once or twice in a lifetime."5 Market failure due to information asymmetry has been a consensus intervention ground, and mandating disclosure from lenders to consumers a consensus intervention type.[6]

In mortgage finance, for example, the true costs of credit, the character of interest rate adjustment mechanisms, or loan termination conditions may be hidden from the consumer prior to loan closure. The Truth in Lending Act of 1968 in the United States, as a reaction to this, focuses on such disclosures. Roman law countries address the issue in their civil codes and special laws; for example, on disclosure of credit costs and terms.

Information asymmetries are even more pronounced in emerging markets, given that access to information is more constrained—for example, through a greater "digital divide"—and competition may be less active because smaller markets and lenders may have shorter histories. A frequent asymmetry arises if contracts are very complex because of the risk environment; for example, indexed products with ballooning debts that respond to inflation risk and may lead to residual debts for the consumer (see discussion below on Mexico and Brazil).

5. Guttentag 2002.
6. Credit market failures resulting from information asymmetry has been a key topic of economic research of the past 25 years. For an overview, see Stiglitz 2000.

Consumer Heterogeneity

Transparency standards do not overcome deficiencies adherent to the consumer's identity that disable him or her from overseeing the implications of closing a contract, limit the rationality of his or her market behavior, or render him or her a more likely a victim of abusive practices. Research in the United States shows that factors such as culture, education, and access to information matter in this regard, and that these factors are regionally concentrated.[7] To the extent that lenders systematically exploit these asymmetries, market failure may be the result. For example, so-called "predatory" lending practices to vulnerable groups may lead to predictably high default rates, ultimately leading to market breakdown because of spiraling costs. The current "subprime" lending default crisis has led to a breakdown for parts of the U.S. mortgage market, especially lending to minorities.

The main approaches to addressing consumer heterogeneity are to force lenders to disregard elements of the identity of the consumer upon underwriting (antidiscrimination), to penalize detrimental advice given by lenders and brokers to consumers under conflict of interest, and to enhance consumer education levels. The United States, which is characterized by both a very deep mortgage market and a great variety of consumers, has the most developed regulations in that regard.

Yet, abusive practices in the subprime market show how large the regulatory gaps still are.[8] Anti-discrimination and conflict-of-interest rules are starting to take hold in Europe, but so far not systematically.[9] Emerging markets still usually lack such standards. Consumers tend to be less educated in financial affairs, although in high-inflation environments, depending on individual education levels, the reverse has also been true.[10]

7. For example, Deng, Pavlov, and Yang (2004) find that borrowers from affluent western Los Angeles both refinance and move quicker than predicted by standard estimation techniques, while those in less affluent areas tend to stay longer than expected with their properties and loans.
8. A typical abusive practice in the U.S. subprime market has been to refinance fixed-rate loans into adjustable-rate loans with low initial "teaser" rates. In subprime, those teaser rates end after one to two years, resulting in a massive payment shock for borrowers as rates adjust to the fully indexed and fully amortizing level. Such refinancings were targeted at financially non-astute borrowers. The United States is now discussing a "suitability" standard in order to eliminate such and other practices.
9. Low, Dübel, and Sebag-Montefiore 2003.
10. For example, Argentinean consumers, hardened by decades of high inflation, are famous for their astuteness in financial management. The country has several daily newspapers dealing

Transaction Cost Asymmetries during the Going Concern

Material consumer protection in mortgage finance largely deals with assigning rights to consumers or limiting lender rights in order to reduce the impact of transactions cost asymmetries. Examples are price discrimination against consumers with seasoned contracts (for example, if loan rates can be unilaterally adjusted by the lender), rights to assign the loan to another lender that might impair the value for the consumer, and high charges or legal mechanisms that lenders may use to block early repayments. The reverse problem may arise, however, when contract law assigns consumer options that exploit lender transactions costs; for example, a consumer right of transferring the mortgage to another property, caps to indemnities on prepayments leading to a loss for the matched-funded lender, or options to delay foreclosure in case of default.

Because of the important cost effects of material consumer protection, approaches in practice have varied greatly. In the United States, the states enforced strong material consumer protection rules until the early 1980s, when federal deregulation overruled them.[11] In the EU, because of the large national differences in contract law the commission until today has not been able to expand the ambit of the Consumer Credit Directive of 1987 to mortgage lending (see box 6.1).[12] Material consumer-protection issues in the area of mortgage finance are also becoming increasingly prevalent because of the surge of consumer-protection legislation in emerging economies in the past decade.

Vulnerability of the Consumer to Market Risks

Mortgage lending overcomes the information asymmetry of a lender about the solvency of a consumer through collateralization, and is therefore an inexpensive form of consumer credit. The downside for the consumer is the cost of pledging the collateral; in the extreme case, the loss of his or her primary residence and most important pension asset. High externality costs

exclusively with investment and personal finance issues.

11. Saunders and Cohen 2004.

12. Dübel, Lea, and Welter 1997.

Box 6.1. "High" and "Low" Levels of Consumer Protection—The Clash of Approaches in Europe

Within the EU, there is considerable diversity of consumer protection regulation in mortgage lending. Among the larger nations, France has traditionally regulated material consumer protection issues more in-depth and in favor of the consumer than Germany and the United Kingdom. The Consumer Credit Directive of 1987 gave the starting signal for the creation of EU–wide minimum standards, to be eventually imposed on mortgage finance. From the beginning, it was subject to strong controversy:

First, even a low common minimum was not easy to find, because of strong historic differences in mortgage market practices. The most prominent examples were annual percentage rate (APR), early repayment, and rescission. A common APR definition was found to be problematic even for a majority of European products, in particular the dominating variable-rate products. German lenders objected to a universal prepayment option for fixed-rate mortgages in order to legally protect their matched-funding mechanism, Pfandbrief. Danish lenders refused to accept a rescission period because their regulation would not allow them to take pipeline risk.

Secondly, the proposed EU approach of minimum harmonization left room for countries with "higher" levels of national consumer protection to adopt stricter regulations. This meant that national regulators could use, and in fact do use, consumer protection as a trade barrier against foreign entry. For example, France, which limits prepayment penalties, could block German or British mortgage products coming with higher prepayment penalties. Germany, which effectively bans indexed products, could block most Spanish or Portuguese products.

The lesson from the European debate is that idiosyncratic market practices require considerable attention in law formulation and tend to lower the regulatory minimum unless they converge through competitive forces. Regional mortgage markets are also almost impossible to create without a strong political unifying force. Maximum harmonization could be a solution—that is, a positive-definition consumer law imposing deregulation on some members. The United States has historically followed such an approach by enforcing product standardization through the secondary mortgage market and federally regulating state law—so far with mixed results (see box 6.4).

for society may be the result if economic shocks—for instance, large house-price cycles or interest rate increases—force many consumers simultaneously into default. In developed markets, public housing and pension safety nets provide such defaulting consumers with a minimum of tenure and old-age retirement income security. In emerging markets, where shocks also tend to be more frequent and severe, absent sufficient safety nets, defaulting consumers are often left on their own.

Material consumer-protection standards, primarily concerned with the going concern, usually assign the costs of such cyclical or catastrophic risk to lenders, consumers, or government in an unsystematic fashion. Even in the United States, with well-developed foreclosure laws and strict practices, foreclosure prevention that might lead to loss minimization for both consumer and lender is still nascent. This is also typical for many Commonwealth countries. In France, by contrast, foreclosure prevention is the focus of an elaborate piece of consumer protection legislation, the *Loi Neiertz*. In Latin American markets, which experienced large interest-rate and house-price shocks, the lack of foreclosure prevention, inexperienced regulators combined with insufficient housing and pension safety nets has induced courts to intervene systematically on behalf of consumers, often resulting in significant losses for lenders. Where foreclosure was easily possible, in contrast, excessive forced sales rather than foreclosure prevention have worsened house-price declines (for example, in parts of Mexico during the Tequila crisis).

Protecting the Consumer through the Loan Life Cycle

Before Borrowing

Disclosure

The U.S. Truth in Lending Act requires lenders to disclose to consumers for closed-end loans, among other things, the finance charge, the annual percentage rate (APR), the amount financed, and the total of all payments. Enhanced disclosure is required in other laws for "federally related mortgage loans"[13] and subprime mortgage loans with very high interest rates.[14] Disclosures in the United States have been criticized as cumulative and confusing, overreaching the information-absorption capacity of the consumer.[15] The European Union Home Loan Code, adopted in 2002, remedies some of the information overload by mandating a single information sheet for consumers; however, national regulations in Europe often go into much greater detail and cause similar problems as in the United States.

In emerging markets, unfair marketing is still a widespread problem, as lenders in most jurisdictions are not forced to disclose loan costs systematically. Recent regulations have started to address the issue. Box 6.7 reports the Mexican example.

Accurate loan disclosure is a sine qua non in mortgage finance. In particular, in countries where financial literacy is still not widespread, information given should be simple and understandable, and if possible it should be explained by independent parties to consumers (for example, consumer groups).

Annual Percentage Rate of Charge

The APR is central to the concept of disclosure. Box 6.2 discusses the conceptual problems of capturing different mortgage products in a single APR computation, which is impractical. Comparing APRs makes sense only for products with comparable terms and options content.[16] Choosing the right APR ambit is also pivotal: the U.S. Federal Reserve, which implements the Truth in Lending Act, requires interest, fees, points, and private mortgage insurance (if required by the lender) to be included in the APR. Title insurance, document preparation, appraisal fees, and other mandatory fees, how-

13. Real Estate Settlement Procedure Act. Most middle-income and practically all low-income mortgage loans in the United States are guaranteed by the federal government agencies or government-sponsored enterprises.
14. Home Ownership and Equity Protection Act; see discussion in box 6.5.
15. Guttentag (2002) and U.S. HUD and Treasury (2000) criticize the dual responsibility of Federal Reserve System (Truth in Lending Act, Home Ownership and Equity Protection Act) and HUD (Real Estate Settlement Procedure Act).
16. Guttentag (2002) proposes to compute APRs over multiple terms or over loan terms as specified by the borrower.

Box 6.2. Defining the Annual Percentage Rate of Charge

The APR is defined as the internal rate of return of future payment streams from consumers to lenders. Such a computation assumes a constant duration of the loan and invariability of loan terms over time. Unfortunately, since mortgages are pre-payable and often priced at variable rates or rates reset periodically, both assumptions are violated as a rule, rather than an exception.

Consider a standard variable rate loan with a two-year initial period of low fixed rates ("teaser" rates). This is the most frequent loan product in the United Kingdom, and gaining in popularity in the United States ("hybrid" ARM). For such a product, taking the APR over the fixed-rate period is misleading—it is known in advance that rates will not remain constant. Even the concept of an "initial" APR—comparing the teaser rates only—is misleading, since the lender can "claw back" any discount by overcharging in the variable rate loan phase. In contrast, so-called "tracker" ARMs following an interest rate index with constant contractual spreads can be compared with relative ease.

As a second example, compare the typical U.S. product, a 30-year pre-payable fixed-rate loan, with the typical German product, a 10-year non-pre-payable loan. Since U.S. borrowers frequently exercise the prepayment option, the effective duration of a U.S. loan is between four and seven years, after which a new loan is closed. In effect, the German loan has therefore a longer duration than the U.S. loan; closing costs will be amortized over longer periods, which leads to distorted APR results.

The conclusion is that APR comparisons in mortgage finance only make sense if the option characteristics of mortgage contracts—both on lender and borrower side—are taken into consideration.

ever, are excluded. In France, all third-party costs required by the lender need to be included in the APR.[17]

Despite the problems, an appropriately formulated APR may capture the main features of mortgage loans, which is essential to secure fair competi-

17. Guttentag (2002) suggests adopting broad definitions of all mandatory fees. Dübel, Lea, and Welter (1997) propose for Europe to operate with both broad (all mandatory fees) and narrow (lender costs) definitions.

tion. It is therefore central to mortgage market development. In emerging markets, slow amortization patterns are very popular in order to overcome initial affordability constraints. This invites abuse through high fee incomes spread over the life of the loan. Without an APR, very long-term loans thus appear cheap on rates, although they are in reality expensive.

Consumer Literacy and Counseling

According to U.S. government analysis,[18] financial illiteracy of consumers is at the core of consumer vulnerability to abusive lending practices. Some jurisdictions (for example, the United Kingdom) are therefore passing "responsible lending" rules forcing lenders to ask whether mortgage loans are suited for the consumer.

Lenders, however, face a conflict of interest when being explicitly mandated to perform counseling. The U.S. Housing and Urban Development Department (HUD) has therefore developed a Housing Counseling Assistance Program, under which brokers, housing agencies, charities, and consumer groups are certified and partially funded as counselors. Pre-borrowing counseling, in particular, is mandatory for loans to low-income borrowers that are eligible for Federal Housing Administration (FHA) public loan insurance. Similar certification initiatives exist in the broader market to secure absence of conflict of interest of brokers.[19]

Moreover, in many developed countries, an infrastructure of consumer groups provides counseling. Funding varies from public grants and endowments to consumer journal sales and service charges. Financial regulators or public consumer offices also provide online guides and references to counseling.[20] Consumer agencies, public commissions, and other bodies furthering literacy and counseling are quickly developing in emerging markets; for example, in Mexico (see box 6.7), Poland, or Korea.[21]

Prior to formulating regulations, it seems advisable to clearly analyze the conflict-of-interest situation. Tight lender regulations may be less produc-

18. U.S. HUD and Treasury 2000.
19. For example, the Upfront Mortgage Broker certification system.
20. For example, the British Financial Services Authority and the U.S. Federal Reserve System.
21. For a listing of agencies, see http://www.consumerworld.org.

tive than strategies to develop independent counseling agents, including an endowment with sufficient funding.

The Loan Offer and Closing

Cooling Off

Regulations in developed markets generally allow for cooling-off periods of between three (United States) and 14 days (France, Germany), during which the consumer has the right to unwind the contract. The period is extended in cases where certain selling practices, for example, door-to-door, leave consumers little time to reflect on their decision. Cooling off may be a problem for mortgage lenders, if pipeline risk—the market risk taken by holding a closed, but not yet refinanced, loan—is high.

In emerging markets, a conflict may arise from a greater need for the consumer to reflect on his or her borrowing decision, especially if there is poor access to information and greater market risk for the lender. This would speak in favor of greater emphasis put on information and counseling, and curbing selling methods that rely on spontaneous decisions, such as door-to-door selling.

Circumvention of APR and Risk of Over-indebtedness through Cross-selling

Cross-selling of mortgages with other finance products, most notably insurance, may lead to the circumvention of APR rules and conflict of interest of lenders between serving the consumer and adding income from a third source. The requirements for and length of mortgage insurance coverage is a highly contested issue in the United States. Kickbacks and referral fees to originators have been put under threat of criminal penalty by the Real Estate Settlement Procedure Act for "federally related mortgages." In countries that allow tax deductibility of both mortgage interest payments and insurance premia or contractual savings contributions, endowment mortgages paid down by life insurance or mutual funds are popular. If nonperforming, these instruments carry the risk of leaving consumers with residual debt.

Cross-selling poses a certain risk in fast-growing emerging markets that have weak or no APR frameworks and favor indebtedness through mortgage interest deductibility. Incentive structures should be set so as not to artificially favor indebtedness; for example, through leverage-neutral taxation. Broad APR definitions are needed to enable the consumer to capture the cost effects of cross-selling.

Discrimination and Predatory Lending

The U.S. Equal Credit Opportunity Act bars discrimination based on age, gender, marital status, race, color, religion, and national origin. In addition, U.S. federal agencies and government-sponsored enterprises are held to promote lending to underserved groups.[22] Similar policy instruments exist in the United Kingdom, but are still in their infancy in the rest of Europe. The "reverse redlining" problem lending to borrowers without regard to their ability to repay at exorbitant interest rates has been related to the deregulation of the U.S. mortgage market. Box 6.5 describes the ongoing struggle to find a balanced regulatory framework in this area.

In many emerging markets, regional and social heterogeneity is high, and so is lender redlining. Examples are multiethnic states (for example, South Africa and Iran) or states with high income inequality (for example, Brazil and India), or both. South Africa had passed antidiscrimination rules for mortgage lending in the early 1990s; however, real progress to greater down-market penetration required the gradual emergence of new lender groups specializing in low-income lending.

Some emerging markets also operate public banks that distribute loans at highly favorable terms. Anecdotal evidence would suggest that this circumstance has favored requests for kickbacks by bank officials. Such situations can be resolved to the extent that the incentive for kickbacks, subsidies, is weakened, or penalties are increased. While there is no immediate predatory

22. These policies have not always been effective, as the recent almost-complete substitution of U.S. federally insured fixed-rate lending (FHA, variable annuity) through mostly adjustable-rate private-sector subprime lending demonstrates.

Box 6.3. Prepayment Indemnities—How Much is Too Much?

Fixed-rate lending may all but disappear (Spain) or become considerably more expensive (Denmark, United States) if prepayment indemnities are not practiced, capped at marginal levels, or even banned by consumer protection rules.

But even the most lender-friendly regulations (Germany) limit yield maintenance prepayment indemnities to a period of 10 years—a wholly arbitrary figure—to avoid very large amounts. Moreover, should the calculation of yield maintenance be allowed to include the lost future income of the lender from the loan, which, if not charged, without doubt would raise the costs of future lending? What should the policy be in "hardship" cases (for example, a forced move, divorce and so forth)? Finally, should the lender be required to disburse reinvestment gains that may arise if a borrower prepays during an interest rate rise?

The solution to some of these problems may be found in technology; for example, Danish non-callable mortgages can be prepaid through delivery of mortgage bonds, which means automatic disbursement of reinvestment gains and disregard of lost future lender income. In any case, solutions will require an informed economic judgment balancing the interest of lenders and consumers.

lending threat for emerging markets, excessive debt service burdens often arise with high levels of inflation, especially if inappropriate loan instruments are used.[23]

The Ongoing Concern

Back-book Price Discrimination

Overcharging of consumers in seasoned contracts is a frequent problem in markets characterized by unilateral reviewable and short-term FRMs. These products are still typical for most developed markets. There is evidence that seasoned borrowers of U.K. standard variable rate loans and German reset

23. For example, as a result of the so-called tilt effect of fixed-rate loans under high inflation, typical initial debt-to-income ratios in Iran by loan closing approach 50 percent.

fixed-rate mortgage loans are charged 50–150 basis points more than new borrowers upon rate adjustment.[24] Absent a fixed-rate market, contract terms are frequently unilaterally reviewable in emerging markets, especially in the Commonwealth countries that are dominated by the British thrift tradition, and in Arab countries.

Techniques to address price discrimination include the introduction of long-term fixed-rate mortgages (United States, Denmark), the specification of pricing benchmarks for short-term FRMs (Thailand, Canada), and mandatory linkage of adjustable or short-term fixed-rate contracts also to external benchmarks (France, Spain, Mexico). Benchmark provision for mortgage lending usually requires the active support of the Central Bank.

Early Repayment

Consumers in developed markets enjoy a universal right of prepayment.[25] The value of that right, however, is frequently neutralized through indemnities in order to protect funding instruments. The United States liberalized the charging of indemnities in the 1980s; however, the purchasing practice of the federal agencies in the secondary mortgage market marginalized loans carrying them. In Europe, regulations vary between strict limits (France) and indemnities that allow the lender to recover his or her financial damage (Germany, Sweden). In some jurisdictions, court practice has eroded their amount (United Kingdom, Netherlands). Box 6.3 describes the problems of defining a consistent regulation.

Fixed-rate lending in emerging markets almost invariably carries legal ambiguity about early repayment, which raises the risk of lender reinvestment loss once inflation and interest rates fall and prepayments occur. Examples are Russia and Iran, where loan rates are fixed in local currency over the long maturities (15–20 years). Because of the potential scale of losses, lenders are tempted to block prepayments in such situations, which may force consumers to seek court arbitration.

24. See Low, Dübel, and Sebag-Montefiore 2003.
25. An exception is Germany, which allows legal exclusion of prepayments in cases when these are primarily motivated by financial considerations of the consumers.

It seems advisable for emerging markets to aim at a basic, yet fundamentally complete, set of fixed-rate contracts with and without prepayment protections. In the latter case, the consumer would save the option premia while having to pay an indemnity at prepayment, for instance for loans with rates fixed up to about five years. The Danish mortgage market holds a good example for the coexistence of these products.

Interest Rate and Exchange Rate Risk

Mirroring the previous two issues, excessive debt service arising in interest-, inflation-index-, or exchange rate-linked mortgage contracts has been a subject of interventions on behalf of consumers. Indexation schemes are frequently pegged to short-term market rates, which tend to be highly volatile. Exchange rate risk may render seemingly cheap fixed-rate loans that are denominated in foreign currencies highly expensive after a realization. Both issues are particular virulent in emerging markets. Recent court orders ruling in favor of consumers, when large interest-rate or exchange-rate shocks occurred, have been recorded, for example, in Colombia[26] and Argentina (see box 6.4).The conclusion from those cases would be to focus on pricing benchmarks that are good measures of long-term capital costs.[27] Foreign-exchange risk in mortgage contracts should ideally be avoided, unless protective hedges or caps are available to the consumer or consumers receive incomes in foreign exchange.

Usury regulations are without doubt the oldest material consumer-protection instrument.[28] Usury rates are not determined a priori in most European legislations and the burden of determination of abusive practices is laid on the courts. Where rate formulations exist, they define a threshold as

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26. In Colombia, the default crisis of the early 2000s was linked to a large real shock on interest rates. This triggered a judgment by the Constitutional Court that ruled that the variable mortgage rate index used by the housing finance institutions (the UPAC), which was based on average nominal interest-rate levels, was invalid and that an inflation-based index should have been consistently used. This forced the government to refund borrowers for payments made in excess of the inflation-based index.
27. This would be measures of long-term interest or inflation rates, which can be derived from market signals. An example would be the Brazilian *Tasa Referencia* (or reference rate), a forward-rate measure of future interest rates.
28. The canonic prohibition of taking interest was lifted in Europe only in the 16th century. Until the 20th century, usury ceilings were mostly the only element of material consumer protection.

Box 6.4. Foreign Currency Mortgages—Low Rates, High Risk

Foreign currency mortgages are an important example of loan products with high future payment-shock potential for consumers, and, by implication, high default risk for the lender. The type of risk is analogous to price-level-adjusted contracts in local currency: foreign currency mortgages imply a periodic adjustment of the outstanding balance in line with the devaluation of the currency. Yet borrower salaries, which are usually paid in local currency, are unlikely to rise smoothly at the pace of devaluation, and in many emerging markets there is risk of shock devaluation as a result of economic or balance-of-payment crisis. To the devaluation risk is often added interest-rate risk in cases where rates in foreign currency have been chosen as adjustable in order to depress initial interest payment further.

Despite these risks, foreign currency mortgages have grown in popularity throughout the world, and particularly so in two regions:

- In Latin America, a large proportion of debt is traditionally dollarized as a result of the legacy of hyperinflation. There is considerable mismatch risk for banks, since loans are even more dollarized than deposits; Peru, for example, has around 70 percent of all its deposits and 75 percent of its loans in dollars, with over 90 percent of mortgage loans in dollars.
- Eastern Europe has also seen high levels of foreign currency lending, with loans being advanced in euros, Swiss francs, or Japanese yen. Although the interest rate differential has fallen in recent years, foreign currency loans remain popular. Poland, Hungary, and Ukraine have all seen high levels of foreign currency loans. In Estonia, foreign currency loans represent 88 percent of total lending.
- Particularly risky for lenders are large shock devaluations after long phases of fixed-exchange rate policies, which encourage indebtedness in foreign currency. In Argentina, as of 2001 the entire mortgage portfolio was denominated in U.S. dollars and financed with U.S. dollar debt. With the breakdown of the fixed-exchange rate policy and the devaluation of the peso—by 75 percent at one point—the

(continued)

Box 6.4. Foreign Currency Mortgages—Low Rates, High Risk *(continued)*

> government in early 2002 decided to "pesify" all consumer debts, rather than allow an adjustment of the credit outstanding debt due by borrowers, as contractually agreed.*

Wary of high payment shocks for borrowers, regulators in Poland have responded by taking a stance against further growth in currency lending. A new regulation was put into force in July 2006 that includes a consumer education and awareness initiative. Consumers have to show that they are actively rejecting a domestic currency loan by signing a declaration to this effect. An information sheet with details of the risks of the products being purchased also must be given to the customer. The second strand in the supervisory response is to tighten the underwriting criteria by making banks review the client's creditworthiness based on the higher domestic-currency interest rate only. In addition, the capital requirements for foreign exchange (FX) lending are 20 percent higher, with further changes possibly in the pipeline.

* The forced pesification of liabilities (at a different rate) was only carried out, leading to the downgrade of dollar denominated MBS.

a multiple of or markup over the applicable mortgage rate (Germany, France, and Portugal). In Italy, the *average* market rate cannot be exceeded. In the United States, state usury regulations were dismantled by federal deregulation in the early 1980s, but in response to the tide of subprime lending at extremely high rates, are returning. In the United Kingdom, usury limits were repealed in 1818.[29]

Emerging markets feature the whole spectrum of usury regulations, from prohibition of interest in Islamic finance, to regulatory ceilings in French and German law descendents, to relative liberality in the Commonwealth countries. While predatory lending is less of a problem as long as even middle-class households often do not receive loans, there is potential for abusive charges once the markets deepen. Box 6.5 describes the difficulties in addressing this

29. Not coincidentally, an early fundamental critique of usury regulations was launched by a Briton, Bentham, as early as 1787.

Box 6.5. Consumer Protection in the United States and the Subprime Market

Consumer protection in the United States has traditionally been the role of the states. In a country with widespread federal interest-rate controls originating in the New Deal of the 1930s, state legislation gave rigidly formulated usury interest-rate ceilings a prominent role.

In January 1980, because of inflation, long-term U.S. Treasury rates exceeded 10 percent for the first time in history, and eventually reached 15 percent in 1981. The resulting mortgage rates of 15 percent, 20 percent, and more brought lenders into conflict with the usury laws. In a sweeping attack on state consumer-protection rules, the Reagan administration launched two federal acts (Depository Institutions Deregulation and Monetary Control Act, Alternative Mortgage Transaction Parity Act): the first overrode state usury ceilings and the second outlawed state material consumer-protection rules such as limits imposed on negative amortization clauses and prepayment penalties.

The deregulation of consumer protection enabled the development of the "subprime" mortgage market, a market that since the mid-1980s at the same time provided credit to high-credit-risk households and became the main playing field for abusive lending practices. According to the joint HUD and Treasury report of 2000, in 1999, the median spread over treasuries in the subprime market was 500 basis points, with 18 percent of borrowers paying a spread higher than 700 basis points. Not surprisingly, default incidence in the subprime market in 2001–2 was on average 15 times higher than in the prime market, with one in every 15 mortgages being in default (Saunders and Cohen 2004). Nevertheless, the market grew to an astounding 20 percent of new originations in 2006 (together with near-prime loans with limited documentation 35 percent of new originations). As of 2006–7, the subprime market spiraled into its second major default crisis within a decade, threatening the stability of the entire U.S. mortgage sector by adding to excess housing supply through a huge number of foreclosures.

Federal efforts in the 1990s had failed to seriously address the undesired consequences of the Reagan deregulations. The 1994, Home Ownership and Equity Protection Act had imposed heightened disclosure requirements just for

(continued)

Box 6.5. Consumer Protection in the United States and the Subprime Market *(continued)*

extreme loan spreads over treasuries, which applied to only 0.7 percent of loans, and also did not end abusive pricing or contract clauses. The result is that by 2007—starting with North Carolina in 1999—the majority of U.S. states have started re-regulating mortgage lending. The subprime market crisis since 2007 has even raised the likelihood of a federal re-regulation of the sector.

problem in the United States. A particular problem is that loan volumes in emerging markets are often low, while origination and servicing causes high costs, which may push up cost-covering interest rates to very high levels.[30] It seems therefore not advisable to rigidly control interest rates. Alternatively, lenient ceilings could be adopted, allowing for derogations if lenders can demonstrate that their costs are higher.

Residual Debt upon Maturity

In the interest of minimizing credit risk, mortgage loans should be repaid within their term—ideally before the consumer retires. We have seen above that even with standard products, this constraint is often not properly addressed. Lenders have a profit incentive to minimize amortization in order to retain a maximum base for charging interest. Loans with ballooning outstandings that are adequate in the presence of inflation often entail a heightened risk to generate residual debt. In the United States, such ballooning loans were liberalized in the 1980s. Several European countries, in turn, have put restrictions on such products.

Because of inflation risk, almost all Latin American markets use indexed products that—intentionally—lead to ballooning outstandings, but frequently—unintentionally—end in situations of residual debt at the time of loan maturity. Court rulings have often mandated government or lenders to cancel these debts. While the intended impact has been to protect retired

30. This issues is of particular importance for micro-credits, the transaction costs of which are necessarily high relative to the loan amounts.

Box 6.6. The Legacy of Brazil's Old Housing Finance System

Mortgage market development in Latin America has been constrained by a history of high inflation. High inflation carries the temptation to design products that may lead to large residual debts, especially when political intervention on behalf of borrowers comes into play. The main beneficiaries of such intervention have been members of the upper middle class.

From 1984 to 1993, Brazil, under the Sistema Financiera Habitacional (Housing Finance System) practiced dual-indexed mortgages (DIM), a product in which borrower payments and outstandings due to banks are adjusted to inflation by wage and price indices, respectively. Even in its plain vanilla form, the DIM product is subject to delicate stability issues, since too low initial payment rates may lead to failure of the loan to amortize.

In 1985, political pressure exercised by trade and professional groups in Brazil led to the application of several dozen different wage indices for the DIMs, each representing the wage trajectory of an individual profession. Mortgage payments moreover became systematically under-adjusted to inflation in a mixture of attempts to protect the affordability of borrowers in times of sluggish real income growth and distribution of political favors.

By the early 2000s, a typical Brazilian mortgage borrower of the 1980s—in general a high- or upper-middle-income household—had repaid only a fraction of his debt in real terms. Court interventions on behalf of these groups made sure that residual debt at maturity had to be cancelled by the lenders. To avoid lender insolvencies, a government fund—Fundo de Compensação de Variação Salarial (Wage Variation Compensation Fund)—was created, which by 2001 had produced a deficit corresponding to 4 percent of the Brazilian GDP. Fundo de Compensação de Variação Salarial is part of a larger legacy debt of the Sistema Financiera Habitacional that then totaled 10 percent of GDP and continues to rise.

consumers from losing their home, in many cases such intervention ended in distributing regressive benefits to consumers belonging to the upper middle class, who were given most of the real values of their houses for free. Box 6.6 discusses the Brazilian case, which is far from being isolated.

These experiences suggests that, as a rule, those loan instruments should be given priority that safely amortize within the contracted period even if this comes at the expense of slower market penetration. Moreover, lenders should be required to present the consumer binding amortization plans and, if amortization is contingent on external variables, clearly signal the possible risks.

The Back End: Default

Avoiding Foreclosure and Pre-foreclosure

Avoiding foreclosure and pre-foreclosure is frequently in the interest of both lender and consumer, because of inefficiencies of the judicial foreclosure process. *Loi Neiertz* of 1989 was a formalized attempt to address archaic, but hard to change, judicial foreclosure practices in France: the law defines a formal mediation and counseling process between lender and consumer, in which government plays the role of the mediator. Approximately 90 percent of French default cases are thought to be resolved in such “amicable” solutions (solution amiable).

Even in Anglo-Saxon countries with relatively efficient foreclosure processes,[31] foreclosure avoidance is rising in relevance. During the 1989/90 default crisis, U.K. lenders adopted new strategies to stem the tide of repossessions. Independent arrears counselors were paid by the industry in order to do debt reschedulings and restructurings with over-indebted households. In the United States, after traumatic experiences in the industry downsizing wave of the early 1990s,[32] the public insurers FHA took the lead to develop regulations prescribing loss mitigation procedures, including mandatory debt counseling. Today, even secondary mortgage investors pay servicers premia to avoid foreclosure, for example, through freehanded sales and trading down to smaller houses.

Foreclosure avoidance is still not systematically developed in most emerging markets; however, some of the new consumer legislation has introduced a consumer right for loan restructuring (for example, Malaysia). Con-

31. See Butler 2003.
32. Moore (1989) describes foreclosure practices in Flint, Michigan, after the closure of a large car plant.

sidering the great inertia in undertaking court and bankruptcy reform, the introduction of a better-structured foreclosure process is a promising avenue in most jurisdictions for reducing credit losses for lenders while simultaneously protecting the consumer from residual debt.

Foreclosure

In Europe and the United States, consumers are protected by the need for the lender to obtain court orders and the right to retrieve any residual value of the house after a forced sale. Often, however, there is less protection against high arrears fees and legal charges that may eliminate any such residual value. More importantly, the auction process through courts is frequently illiquid, follows an antagonistic formalism, and leads to less predictable recovery values than freehanded or lender-supported sales.

Court formalism and inefficiency has unfortunately been a successful Western export product to emerging markets. Djankov et al. (2002) show that Latin American courts are leaders in legal formalism, taking up the French and Spanish traditions. They take significantly longer to evict rental tenants than do courts in African or Asian countries with English law tradition. Courts in former socialist countries are found to be the record holders, often asking lenders to provide substitute housing.

Clearly, inability to enforce efficiently through the courts—and parallel absence of meaningful pre-foreclosure arrangements—is a main reason behind the predominance of lease-purchase contracts in many emerging markets. In Brazil, approximately three-quarters of new housing transactions take place through lease-purchase; in Egypt, the share is approximately 90 percent. In lease-purchase schemes, the housing remains owned by the developer until the last installment. Consumer protection in this area has been notoriously weak.

On the other hand, courts in some countries remain extremely lender friendly or even biased toward the lender. In Iran, for instance, lenders can de facto repossess the house and are forced neither to sell any time soon nor redistribute any excess of the proceeds over the loan claim to the consumer.

In most emerging markets, the absence of a meaningful social housing system that could provide housing alternatives for defaulting borrowers is likely to instill some level of court bias in favor of defaulting homeowners.

This is the main economic point behind court delay in Poland, where a constitutional right of housing existed or continues to exist. The Polish government has responded with a program designed to provide emergency shelter for evicted households.

Foreclosure reform is likely to remain an obstinate problem anywhere, because of the power of legal traditions. Governments can create emergency housing solutions to give comfort to courts. Court reform itself should be high on the legal reform agenda. Specialized courts or tribunals (see below) may constitute alternative, more effective foreclosure mechanisms.

Consumer Insolvency and Discharge

Dealing with residual debt after a foreclosure is the third element of consumer protection at the back end. A formal consumer insolvency law is now the standard in the United States and Europe. Solutions vary as to whether the lender is forced to choose between collateral and other consumer assets (United States) or can go for both (Germany). After the German reform of 1999, consumers in the EU are now generally discharged of their residual debt within three to seven years; however, residual income burdens and collaboration duties imposed on the consumers vary. In emerging markets, a flurry of general consumer protection legislation has been passed since 1995, which may be expected to create similar concepts of consumer insolvency.

In economic terms, residual debt discharge is a double-edged sword. On the one hand, it strengthens the collateralized nature of mortgage credit and avoids the "eternal debt tower" that treated consumers unfairly in many historic private law formulations. On the other hand, it provides additional incentives for consumers to see a mortgage default as an economic option whose exercise will come at the expense of the collective of performing borrowers, if house prices fall, for example. Lawmaking efforts in emerging markets should strike a middle ground to keep debt performance incentives for borrowers intact.

The Costs of Consumer Protection

Opportunity Costs of Regulation

There is little doubt that disclosure requirements, consumer education, and public certification and counseling measures yield high returns in a cost-benefit analysis. As the experiences presented above show, however, some degree of material consumer protection is needed, because significant abusive practices and risks for consumers prevail. Moreover, the benefits of internationalization and globalization for all consumers cannot be reaped without a level playing field of products across jurisdictions.

Whether that field should be wide or narrow is the subject of legitimate debate. Absolute protection of the consumer from abuse or risk is neither practical nor desirable. Material consumer-protection regulations may lead to the unintended disappearance of products or increases in the price of the mortgage for the consumer. In addition, the structure of the mortgage industry may become less competitive; for example, if lender growth strategies through product innovation become impossible to realize through excessive product standardization.

As in the analogy of durable consumer products, imposing greater consumer options in mortgage finance will increase product costs: for instance, in the case of the universal prepayment option on a 30-year loan, the rate increase is estimated in the range of 70–100 basis points.[33]

The exact costs, however, of reduced product choice and growth opportunities are hard to assess in quantitative terms. They depend moreover on the amount of substitution goods available; for example, curbing the subprime market through rate ceilings may efficiently induce more subprime borrowers to stay renters, if there is sufficiently elastic rental housing supply.

Moreover, costs are often contingent rather than current and explicit; for example, if consumers, because of restrictions imposed on fixed-rate mortgages, are encouraged to take up more adjustable-rate debt, the main cost factor is the increase in insolvency risk, which may or may not materialize in the future.

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33. See Dübel and Lea 2000.

Consumer protection rules may also interact with banking regulations and public-mortgage-market intervention in a way that reduces product choice and competition. Examples are the high-LTV and subprime mortgage markets, where lenders are bound by increased transparency, counseling, and usury pricing rules while banking regulators curb risk taking. Where, however, does a valid market end and where do abusive or excessively risky practices start? The experience of the U.S. subprime market suggests that the seesaw of deregulation and re-regulation may produce more pronounced distortions than a consensus regulatory approach would have.

The task when formulating consumer protection rules is therefore to try to identify, quantify, and strike a balance between these current, future, and contingent costs of regulation and the benefits from reduced incidence of abuse and risk for the consumer. Such a decision must be supported by sufficient microeconomic analysis of the mortgage market, which requires a minimum of data dissemination and analytical capacity.

Alternative Implementation Forms, Costs

Does the form of regulation matter for its cost-benefit balance? Industry self-regulation, for example, through codes of conduct or pre-commitment approaches to certain policy goals, has been popular, in particular if agreement over a new law could not be obtained.[34] They may serve as a collective bargaining mechanism to build consensus between stakeholders, first within industry and consumer groups, then between industry and consumer groups, and finally between both and government. They also introduce an element of market testing, which is often missing in cases of government fiat.[35]

In practice, voluntary agreements seem to end invariably in formal regulation, because they tend to treat disputed areas by negligence rather than enforced political compromise. In the United Kingdom, the voluntary Mortgage Code, a lender Code of Conduct of 1997, has been replaced by compulsory Financial Service Authority (FSA) rules. The EU Home Loan Code

34. Dübel, Lea, and Welter 1997 proposed such a code of conduct to overcome the gridlock over the transposition of the Consumer Credit Directive in the EU.
35. See Guttentag 2004.

covers only partial aspects of consumer information and required seven years of negotiation between industry and consumer groups. It is widely held to fall far behind the consumer protection agenda and will likely make room in due course for an enlarged Consumer Credit Directive.

Enforcement Costs

Whatever the scope and form of regulation, consumer protection needs a clear enforcement structure. Regulations must be developed, revised, and enforced, ideally by a single public body with a clearly defined mandate (see box 6.7 on the Mexican case).[36] Institutions providing consumer information, education, and counseling must be funded; they can be established by government itself (housing agencies, local or state housing offices), consumer groups, charities, or independent brokers and debt counselors. To settle conflicts in the going concern or an early stage of foreclosure, special tribunals or extrajudicial mechanisms, such as third-party arbitration and ombudsmen, have proved valuable.[37]

Court reform itself may add to efficiency if foreclosure cannot be avoided. A clear coordination between different agents in increasingly disintermediated financial systems is also important. Credit investors should provide incentives to servicers aimed at facilitating debt restructuring and rescheduling, and where private responsibility for settlement ends and the public safety net starts should be clearly established.

36. Guttentag 2002 notes the conflicts between Federal Reserve and HUD in the United States. Germany has started a consumer protection ministry that may rival the consumer protection role of the federal financial regulator, Bundesanstalt für Finanzdienstleistungsaufsicht (Federal Financial Supervisory Authority; BAFIN). France uses a single agency for the housing and housing finance sectors, L'Agence Nationale pour Information sur le Logement (National Agency for Housing Information).

37. Examples for tribunals are the Malysian Tribunal for Consumer Complaints, the Indian system of national and state commissions and district fora for consumer affairs, and the French system of *Tribunal d'Instance* dealing with over-indebtedness. Portugal has an independent national arbitration center for consumer credit. Independent ombudsmen originated in Nordic countries and have been successful in the British and German banking and insurance industries.

Is Consumer Protection a Luxury Good for Emerging Markets?

Emerging Markets Are Part of the Global Consumer Protection Trend

Consumers International, a global representation of consumer groups and agencies worldwide, reports that consumer protection laws have been passed since 1995 in many emerging markets, mostly in the form of general consumer protection acts. This follows the 1985 passage of UN Guidelines for Consumer Protection. Edwards (2003) indicates that progress is greatest in Latin America, where all countries except Guatemala, Cuba, the Dominican Republic, and Bolivia have passed laws. South and East Asian countries (for example, Indonesia and Malaysia, both in 1999) did likewise, while less developed South and Central Asian countries are lagging behind. In Africa, South Africa—through the excellent National Credit Act of 2005—and some other countries such as the Seychelles and Botswana have consumer protection laws, and a number of others are preparing them. A 2000 report by the group summarizes policies and institutions in Central and Eastern Europe, which are being transformed from their socialist predecessors, rather than recreated.

Appropriate Regulations May Support Financial Sector Development

The New Institutional Economics literature, developed among others at the World Bank, has stressed the importance of appropriate regulations for economic development. Applied to mortgage finance, the notion of appropriateness implies recognition of the specificity of an emerging market with regard to the lender, product, and risk environment.

The implication on expanding a housing finance system may be changes in weighting or priority; for example, between consumer information and material protection rules. For instance, improving information may be a priority in markets with fierce price competition on standard products, yet sees frequent acts of misstatements by some lenders to make the costs of credit appear less expensive. In contrast, material protection interventions may be a priority in markets featuring products with payment shocks (for example, foreign currency lending) that may increase over-indebtedness risk.

Ideally, the latter situation should be avoided altogether, and mortgage products should be initially kept simple and at low risk in the interest of all parties. In this situation, the regulatory focus will be on the front and back ends of the loan life cycle.

- Concerning loan closing, emerging markets should require, in parallel, sufficient loan disclosure and minimum contract content. They should support consumer education and assistance efforts. The simplest means of disclosure should be adopted, for example, self-explanatory, single-page term sheets and the mandatory quotation of the APR for the main product classes. Consumer groups will typically provide pre-closing education and assistance on loan offers against minimal, but ideally systematic, public financial support. Such measures will also improve the competition environment and be welcomed by most lenders.
- Functioning pre-foreclosure, foreclosure, and consumer insolvency regimes, as well as a safety net for defaulting consumers, are also central.[38] Courts (foreclosure, eviction) and local governments (re-housing the evicted) must be enabled to fulfill essential support functions. The servicing departments of lenders, however, should also receive training by, for example, public agencies to help avoid foreclosures that may produce lower recovery ratios than workouts and other pre-foreclosure techniques in many situations. For instance, during the Tequila crisis of 1994 in Mexico, a rush by lenders to foreclose lead to a spiraling price decline that maximized losses.
- An ombudsman, created by an industry group or with the regulator, can improve consumer-lender communications and avoid many court cases.

38. Without a social safety net in the form of alternative, lower-cost housing available for defaulting homeowners, it is likely that even the most balanced set of foreclosure regulations will meet resistance from courts. This is one of several areas where broader housing policies and consumer protection rules need synchronization.

Box 6.7. A New Consumer Protection Framework for Mexico

The Federal Law on Transparency and Promotion of Competition in the Guaranteed Credit Market of 2002 introduced minimum consumer protection standards for mortgage finance in Mexico.

In the fields of disclosure and transparency, the law defines a total cost of credit concept, a disclosure standard for contract terms, a binding loan offer period of 20 days, and appraisal standards and authorization of appraisers, as well as minimum contents of contracts. The federal housing finance agency, SHF, is mandated to provide monthly comparative loan-offer information to consumers.

As expected, in an economy with a history of high inflation, material consumer protection concentrates on setting rules for interest rate adjustment. Variable rate contracts are permitted if they follow a public reference rate. Spreads over the reference rate may vary only within contractually determined limits. Prepayment of fixed-rate loans is not generally cost free, but the Central Bank and Federal State Secretary for Economy may jointly determine prepayment conditions and penalties to be then paid. Prepayment charges for variable rate loans, however, are limited to 1 percent. There are no usury ceilings for interest rates.

While it is too early for a proper evaluation, the current framework can be expected to provide for simplification and greater efficiency of borrower-lender relations in a market historically plagued by frequent court and political interventions. At the same time, there seems to be room for consolidating the supervisory structures that the law created in combination with other consumer protection legislation. Currently, the federal consumer protection agency, Profeco; SHF; the Central Bank; the Commission Bancaria (Banking Commission); and the Federal State Secretary Ministry for Economy share responsibilities for detail formulation and enforcement of consumer protection regulations in mortgage finance.

There are situations where developing more complex products or products with potential payment shocks is unavoidable, for example, in the presence of inflation risk. Even with full disclosure and guidance, many consumers will not understand these products. Central banks or regulators here can support appropriate product regulations, for example, through providing appropriate base indices for rate adjustment and establishing simple pricing and re-pricing rules. Public agencies can provide lenders with caps or swaps (foreign currency, interest rates, negative amortization) to protect against the downside risks of such products, which should not fall on consumers.

The Mexican example reported in box 6.7 seems to be a good reflection of these specificities. It strengthens the front end—information and disclosure—and structures the going concern only as far as the main risks—inflation risk—are concerned. It should be noted that the federal housing finance agency SHF offers swaps to lenders in order to shield both borrowers and lenders from certain price risks of the dominant mortgage product used in Mexico.

Understood as a means of structuring the relationship between lenders, consumers, and government without introducing excessive legal formalism, consumer protection is not a luxury good for emerging mortgage markets, but rather an integral part of the overall financial sector infrastructure. It is self-evident that emerging market countries should use their chance to avoid the mistakes of many developed markets, which have found themselves in repeating deregulation and re-regulation cycles following changes in political colors and, often, overregulation.

Conclusions

Both consumer information and material protection rules are a necessity in an industry characterized by information asymmetries, consumer heterogeneity, transactions costs, and complex products carrying multiple options. It is the degree of standardization of lender covenants and products, not the fact that some standardization must occur in the interest of the weakest consumers, that is a worthwhile subject of debate.

These economic points have been blurred in the understandable thrust to deregulate an overregulated mortgage industry in developed markets of the 1980s and the subsequent polarized policy debate. Much of that debate can be traced to the traumatic experiences of high inflation and is increasingly obsolete. Today, the practical difficulties in determining an appropriate level of consumer protection should have priority. These arise because of the idiosyncrasies of mortgage lending, especially funding and risk management mechanisms.

The trend in emerging markets has been to quickly develop their consumer protection frameworks. For them, in the mortgage sector, in particular, the front end—consumer information and education—and the back end—foreclosure, eviction, and insolvency, should be the central focus of a strategy to develop adequate regulations. Appropriate regulations and institutions should be created that ease the burden of courts and reduce the widespread political risks. This also requires an economic support strategy; for example, supporting institution building of courts, local governments, consumer groups, or, more radically, alternatives to homeownership for those completely unable to borrow safely. An initial limitation to simple, low-risk mortgage products that require less legal structure and impose less regulation costs will be in the interest of all parties, lenders, consumers, and government.