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The Rising Risks of Mortgage and Consumer Credit in Middle-Income Economies

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The ongoing "subprime" mortgage crisis in the US sharply poses the need to reassess recent trends in the credit systems of middle-income economies. Since the late 1990s, lending in many of these countries has dramatically reoriented towards consumption and mortgage credit, including to poorer households previously excluded from formal lending. The entry of foreign banks has helped prompt this shift, as has the development of secondary markets for such loans.

Most foreign banks in middle-income countries have focused their lending operations on consumer and mortgage credit. A range of domestic financial institutions have followed suit, also developing profitable strategies for lending to individuals (Lapavitsas and dos Santos 2008). Credit to households has grown significantly as a result, including through credit card lending, mortgages, financing by durable-goods retailers, and loans collateralised by borrowers' payrolls.

Foreign banks have also been prominent in the secondary debt markets of middle-income countries, issuing, underwriting and buying mortgage-backed securities (MBSs) and other debt-backed securities. These markets have grown considerably in recent years. In Mexico, for example, US$4.7 billion worth of MBSs have been issued since 2003, US$1.7 billion of this total after the outbreak of the US "subprime" crisis. Most of these securities are backed by mortgages to low-income households. See Figure for trends in consumption and housing loans and shares of foreign bank loans.

World Bank Promotion

The World Bank has been instrumental in promoting these developments through advocacy, research and finance. As early as 1988, it argued for the removal of restrictions on the entry of foreign banks; by the mid-1990s it had also provided the key research papers supporting foreign entry. More recently, IFC programmes have helped finance the expansion of consumption and mortgage lending, granting more than US$1.5 billion for mortgage-backed securities and similar instruments in Latin America, Asia and Eastern Europe between 2004 and 2006.

Not surprisingly, the Bank and many other agencies have welcomed the recent shift towards individual credit. They have promoted new techniques in credit scoring, payroll loans and MBSs in order to increase the access of poorer households to credit. Thus, they believe that they are helping financial markets "work for the poor". Nowhere is this clearer than in the provision of housing for poorer households, where policy has focused on developing secondary mortgage markets to facilitate homeownership (Chiquier et al. 2004).

But the ongoing mortgage and credit crisis in developed countries exposes the grave risks in such an approach. The crisis stemmed precisely from the combination of lending to poorer households, new MBS techniques and the increased operations of leading international banks. All of these features are now prominent in middle-income countries.

The Rising Risks

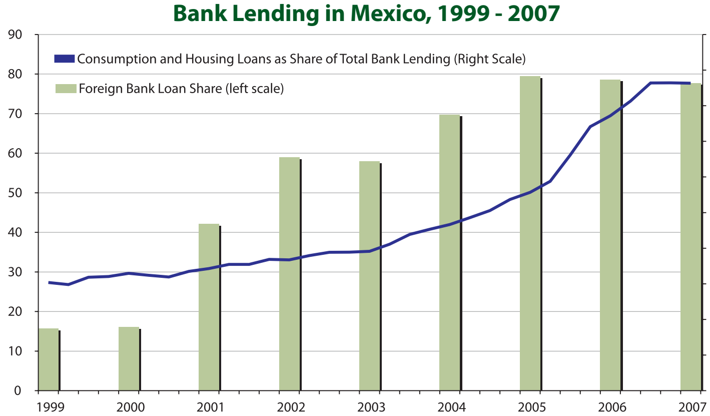
Current levels of mass household debt, which are a severe burden on personal income, are unprecedented around the world. The broader socioeconomic significance and sustainability of such debt are ill understood. This trend is particularly worrisome for households in developing countries, whose incomes are far less secure and more susceptible to macro shocks than their developed-country counterparts.

Evidence from the banking sector suggests that such lending imposes very high servicing costs on households. In Mexico, for example, Citigroup and HSBC received US$1.9 billion in profits last year from lending to households and related personal financial services. Yet there are few consistent measures in developing countries of the growing burden of such debt on personal disposable income.

Moreover, credit scoring and MBS techniques have led to estimates of bank portfolio risk that are based on inferences from the past performance of assets (Lapavitsas and dos Santos 2008). But the boom in lending to households developed during the unusually benign macro picture of the early and mid 2000s. Even a partial return to the type of capital-market and macroeconomic instability of the 1980s and 1990s would likely lead to unforeseen losses by banks and to broader financial instability.

In light of the current financial crisis, it is necessary to review critically the standard policy mix that has supported the reorientation of middle-income credit systems to consumption and mortgage lending. Without significant changes in these practices, middle-income economies will remain acutely vulnerable to crises that are rooted in unsustainable levels of lending to households. The resultant indebtedness would also continue to enhance the transfer of wealth from households to financial institutions. Hence, financial markets would not be "working for the poor"; the poor would increasingly be working for financial markets.

Bank Lending in Mexico, 1999 - 2007



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