Financial Liberalization and the Privatization of Housing Finance Institutions

Bertrand Renaud
The World Bank

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The New Environment for Housing Finance

Around the world, housing finance and mortgage lending are undergoing major changes. Three main trends are driving these changes: globalization, shifting demographics, and financial liberalization.

While the world's financial markets are far from being integrated, the globalization of finance is increasingly apparent, and the necessary technological and regulatory infrastructure is building up rapidly. This trend toward globalization of financial services is marked by extensive financial innovation and increasing cross-border integration of first bond markets and now equity markets. In integrated markets the volume and pricing of fixed-income securities are directly relevant to the performance of mortgage finance markets. Convergence in regulatory frameworks since the Basle Committee first issued solvency rules in the 1980s also has a direct effect on mortgage finance, through regulatory guidelines and sound asset classification rules.

Shifting demographics also have a direct effect on housing finance. Global demand for housing finance is expected to accelerate for four reasons: population growth, increasing urbanization, aging populations, and growth of the middle class. Population growth may finally be tapering off, but at its current rate it takes just 11 years for the world's population to increase by 1 billion people. Over the past 20 years the world's population increased by 1.75 billion people—the same as the total in 1900.

Even more important for the growth of housing finance than global finance are accelerating urbanization, aging populations, and the growing middle class. Nearly half the world's population lives in urban areas. Among richer and more urban countries, population aging will profoundly change the scale and structure of savings markets and pension systems. As already seen in Latin America, pension reforms and institutional investors will play an important role in linking housing finance systems to capital markets.[1] An expanding middle class also means increasing demand for housing and home ownership.

The role of government is also changing with the opening of economies to achieve faster growth. In a closed economy the state absorbs most of the risk in the financial system, and market forces are tempered by regulations and direct and indirect subsidies to selected economic sectors. The liberalization of domestic financial markets has been a precondition for progress on external liberalization in many countries, particularly in the European Union (Kröger, 1993). This liberalization takes many forms—including the removal of special privileges to state institutions, the privatization of state financial institutions, and easier or free entry into the financial sector by other domestic or international financial institutions. This process is more difficult in some countries than in others.[2]

The development of modern housing finance is taking place in the context of major structural changes that are well advanced in the financial sectors of high-income countries and quite visible in middle-income countries:

- *Competition and lower bank profitability*. Deregulation and the liberalization of financial services have increased competition, weakening the profitability and asset quality of banks. The problem has been particularly severe in countries where heavy government intervention in the banking system had led to the institutional decay of banks or prevented their sound development. As a result many economies have experienced major bank failures. In a surprisingly large number of countries, significant parts of the banking system are marginally solvent at best and highly exposed to recessions. Bank profitability is often undermined by the "overbanking" of the domestic market, overstaffing, and low efficiency.

- *Disappearance of market segmentation.* Blurring rapidly is the traditional segmentation of financial markets into different kinds of financial intermediaries that are not direct competitors. This is causing specialized institutions to disappear and a general trend toward financial conglomeration and the coexistence of large groups with specialized financial boutiques. To face competition, these conglomerates are trying to maximize economies of scale and economies of scope, and to diversify their risks.[3]

- *Growth of securities markets.* The development of the commercial paper market and the corporate bond market relies on the large corporate borrowers of banks that are increasingly using securities markets to meet their funding requirements. This is putting pressure on the traditional assets of banks that have to expand their services to smaller firms and other borrowers. Domestic securities markets are also benefiting from the privatization of state enterprises.

- *Off-balance-sheet bank activities.* To make up for reduced revenues in their traditional markets, banks are rapidly developing fee income activities and off-balance-sheet business services. This trend is developing stronger internal links within the financial services industry. In the United States such a strategy has been attracting a lot of public attention. This trend is raising important risk management issues for these banking groups and for supervisors.

- *Changes in funding sources in deposit and savings markets.* The squeeze on bank profits does not come only from their loss of traditional business. Banks are also feeling pressure on their liabilities and low-cost deposits, particularly with the development of money market instruments and mutual funds. Institutional investors (mutual and trust funds, insurance companies, private pension funds) are typically growing more rapidly than deposits. The relative growth rate of deposits relative to other funds is only partly affected by regulators (Blommestein, 1995; Caprio and Claessens, 1997).

These trends are significant for traditional deposit-taking, specialized housing finance institutions operating under distinct charters and usually benefiting from a mix of special privileges and asset power restrictions. These specialized lenders are being confronted with major strategic decisions depending on their competitive strength in domestic markets. In South

Africa the new banking law has abolished the distinction between building societies and commercial banks. In the United States, in the aftermath of the savings and loan crisis, a national commission recommended that savings and loan institutions (thrifts) be abolished and adopt the commercial banking charter.[4]

The United Kingdom has also seen major changes, with large building societies representing two-thirds of the banking sector converting to commercial banks. This move is particularly significant for global markets given the advanced development of U.K. financial markets. Moreover, rather than being structurally weak institutions like the U.S. thrifts, U.K. building societies have long held a strong competitive position. The strategic decision to convert to commercial banks was driven not just by structural changes in the financial sector, but by fundamental changes in the U.K. housing market—with lower inflation, drastic reductions in government assistance for home ownership, less predictability in the labor market, and the development of rental markets (see Coles, 1997).

The U.S. savings and loan crisis offers important lessons for specialized housing finance institutions on the public sector's role during financial liberalization.[5] Four main systemic factors led to the debacle:

- The presence of deposit insurance that permitted weak financial institutions to continue to attract deposits.
- The macroeconomic shock of the rise in interest rates during 1979-82.
- Financial deregulation without adequate supervision, which allowed thrifts to make risky loans in new business areas without fully understanding or controlling their credit risks.
- Relaxed regulatory capital requirements that permitted weak institutions to continue to grow, followed by inappropriate regulatory forbearance in the mistaken hope that insolvent or nearly insolvent thrifts would grow out of their problems.

Where regulation and supervision are weak, financial liberalization creates a risky environment—particularly for specialized lenders that were once heavily regulated. It is not uncommon to find regulators from an earlier era lagging behind in terms of effective monitoring of risks. This phenomenon is far from unique to the U.S. savings and loan debacle; it just happens to be the best-studied case in housing finance.[6]

Privatization: Rationales and Process

Privatization is not a new phenomenon. But it has acquired much greater visibility since the 1980s, first with the policies led by British Prime Minister Margaret Thatcher and then followed by reforms in transition economies.[7] Privatization is now a universal phenomenon, adopted as a strategic economic choice and often as a by-product of political reform. This trend represents an important swing of the pendulum about the best means for achieving faster and better growth.

After World War II many countries emphasized the creation of state-owned enterprises as a way to support and complement private sector development. In those days economists were often concerned about market failures. Similarly, politicians worried that unfettered capitalism would lead to a large gap between the rich and the poor, because the growth rate of earnings on capital would be much higher than the growth rate of earnings on labor.

Today the opposite is true. More emphasis is placed on government failures and on the inability of state enterprises to adapt quickly to the rapidly changing and increasingly competitive world economy.[8] Views about the proper balance between government as producer and government as regulator have shifted in favor of its regulatory role.[9]

Privatization may differ across countries and over time, but it always has two main features. First, it is always an issue of who will control and influence an enterprise. Second, far from being instantaneous, privatization is always a process.

Privatization has proceeded differently in different countries. Some countries have emphasized the transfer of ownership rights. Others have focused on the purpose of the enterprise and its transition to profit-oriented behavior. There is now a strong consensus that privatization means the transfer of ownership and decisionmaking responsibility to the private sector. Intermediate steps may be taken toward this goal, and devolution often starts with corporatization. This step usually implies the conversion of a government administration into an entity that is still publicly owned, but that has a distinct corporate structure, autonomous decisionmaking and staffing ability, and a transparent balance sheet—and that may gain the ability to mobilize financial resources from financial markets.

Many countries are driven to privatize by the need to reduce the burden that money-losing state enterprises place on the budget. In others the dominant concern is to restore growth and dynamism to industrial sectors dominated by state enterprises. A state enterprise may be privatized in hopes that it will achieve better access to international markets. In developing countries that are opening their economies, financial pressures from foreign lenders may accelerate the trend toward privatization. Such financial pressures are correlated with the massive expansion in private capital flows to emerging markets since the early 1990s.

State ownership of banks

Is there a difference between the privatization of a state-owned industrial enterprise and that of a state-owned bank or nonbank financial institution such as an insurance company? New research on financial sector development indicates that the answer is an emphatic yes. The goal and the process of privatization usually differ between a bank and an industrial enterprise. The reason lies in the specific functions of financial intermediaries in terms of mobilizing resources, creating savings instruments, providing risk management, financing innovative entrepreneurs, allocating resources in the economy, and providing payments and other services.

Contrary to the assumption of most economists several decades ago that "where industry leads, finance follows" (Joan Robinson, 1952), research shows that the financial sector should be treated as a distinct, autonomous sector. There is a strong correlation between a country's level of financial development and its ability to continue growing. Private financial institutions are more likely than state banks to achieve efficient resource allocation (see Caprio and Claessens, 1997 and Levine, 1997). Countries privatize their financial institutions to achieve superior information generation and market monitoring—thereby improving the allocation of resources in the economy. Global trends in the financial sector, and in housing finance in particular, intensify incentives for bank privatization.

Rapidly accumulating experience with bank restructuring and bank privatization shows that governance and incentives are the most critical issues for financial institutions (Sheng, 1996). This concern is aptly summarized by the seemingly innocuous observation that noncommercial goals and incentives lead to noncommercial results (Roulier, 1997). Noncommercial goals and incentives are reflected in the issues commonly faced by state-owned banks:

- *Fiscal or market role?* State banks may be used to make policy loans to favored—and often money-losing—enterprises and programs, thereby generating large quasi-fiscal deficits that do not appear in the budget.

- *Special privileges and operating restrictions*. Most state housing banks benefit from privileges that are not available to private banks and so block the growth of private mortgage finance. Such advantages may include stronger foreclosure rights and so lower credit risks, preferential or monopoly use of subsidized deposits, and bank debt securities that enjoy the full faith and credit of the state.[10] In addition, the securities issued by state housing banks benefit from regulatory privileges and can be held by depository institutions to meet reserve requirements. Only the state housing bank is allowed to make loans extending beyond a given maturity. Most state housing banks have a low level of capitalization. In some cases regulatory powers are given to the state bank over the mortgage market. In return, the state housing bank often has restricted asset powers and is obligated to devote a large share of its portfolio to making loans at below-market interest rates.

- *Commercial services or management of public programs?* Many state housing banks have a dual portfolio structure. One set of assets is loans made on a commercial basis. In addition, a large share of bank operations involves the management of various state housing programs for a fee. If the commercial portfolio is poorly managed, most of the bank's income may come from the management fees earned on the public programs over which the housing bank has a monopoly. A policy decision to terminate a major program on which the bank depends or to allow any bank to offer the service may expose the weak earning structure of the housing bank and weaken its potential privatization. In other cases the bank may be losing money on its social housing portfolio.

- *Government control over management appointments and bank personnel regulations* usually erodes the skills and human capital of a housing bank's staff. Over time, government interference and the inability to offer salaries competitive with the private sector leads to adverse selection on the part of bank staff. During and after privatization it may prove difficult to transform the institution from a civil service into a commercial culture. The transition to fully commercial operations will significantly increase risks. Inadequate risk management and supervision are often a problem during the early stages of bank privatization in a liberalizing financial system.

- *Conflicts of interest*. In making decisions for the housing bank, the state has too many conflicting functions as owner, regulator, tax authority, monetary authority, guarantor, and even sometimes as depositor. As a result state housing banks have few incentives to reform well.

Privatization and its participants

Some countries may aim for fast, large-scale privatization. Others may opt for a series of incremental moves. Either way, privatization is always a process—that is, a "time-dependent series of actions for which successive actions are contingent upon present and earlier actions and contemporaneous inputs. The privatization process therefore is best viewed as unfolding in stages and marked by a sequence of milestones" (Syu, 1995).

As was demonstrated a contrario by the nationalization of banks in the Republic of Korea in the 1960s and in France in the 1980s, "privatization, unlike nationalization, is a two-way process. Governments may want to sell companies, but somebody else has to want to buy them" (Grimstone, 1988). Whether planning the privatization of a state industrial enterprise or of a financial institution, three dimensions of the process must be considered: the sectoral preconditions for successful privatization, the expectations and interactions of various stakeholders, and the choice of privatization methods.

Macroeconomic preconditions. It is not possible to discuss the privatization of housing finance institutions without mentioning the broader financial liberalization process and one of its key features: the likelihood of a significant appreciation of the price of nontraded assets, particularly real estate assets, and its potentially deleterious impact on banks. Financial liberalization typically has two phases. First comes liberalization of the domestic financial sector, with interest rate deregulation, the dismantling of directed credit, and the expansion of the asset powers of banks. The privatization of banks, including state-owned housing banks, belongs in that first phase.

The second phase, liberalization of the external account and capital flows, can undo the progress achieved by privatizing banks and mortgage finance institutions during the first phase. A sudden financial opening is often accompanied by a rapid appreciation of asset prices, especially nontradable assets such as real estate assets, that overshoots reasonable long-term equilibrium values.[11] Banks are then exposed to two dangerous forces. At first, a wealth effect will induce rapid growth in credit demand well above sustainable trends. After overshooting upward, the overvalued price of real estate assets can overshoot downward as the real estate boom turns into a bust as real-estate-owned collateral is disposed of by banks (see Renaud, 1997).[12]

But there is nothing inevitable about such unwanted consequences of liberalization, either in terms of destabilizing financial liberalization or a subsequent rash of bank failures. The critical ingredients for successful liberalization are well known. First, the economy needs a well-monitored opening of the capital account, with the avoidance of macroeconomic distortions and a close monitoring of interest rates, exchange rates, and asset prices. A significant upgrading of supervisory skills in the central bank is necessary, including a recognition that the 8 percent capital requirement mandated by the Bank for International Settlements is a *minimum* requirement. This solvency ratio was originally negotiated by the 10 countries with the deepest financial sectors and with large economies less exposed to external shocks of the magnitude often faced by small emerging economies.

Better accounting standards and more public disclosure are essential. Reliable and timely indicators to monitor the real estate sector are also important. Finally, bank managers need to strengthen considerably their credit risk management. Economists and regulators stress the need for incentive-compatible regulatory frameworks, where all key stakeholders have some of their assets at risk and so have an explicit interest in the stability of the financial system.

Stakeholders and their expectations. It is customary to describe the initiation of a privatization as a well-planned, “rational” process based on the deliberate actions of government officials. But in an in-depth study of the privatization of two major state enterprises in Taiwan (China), Syu (1995) shows how and why this is far from being the case. Neither the original decision to privatize nor what happens as the process unfolds can be understood without knowledge of the various interest groups affected by privatization, their concerns, their tactics, and their interactions.

Moreover, in the cases she studied, Syu found that the original impetus to privatize did not originate from the government but from various interest groups, including academics and policy analysts. In one case (China Steel Corporation) Syu identified 19 interest groups holding 28 interests of varying intensity. According to her analysis, these groups pursued their interests using 18 tactics of differing intensity and frequency.

A privatization is as much a political as a technical process. The smooth progress, efficiency, and fairness of a bank privatization may be perceived differently by different stakeholders—some external and some internal to the bank. External stakeholders include legislators, financial regulators (central bank, ministry of finance, line ministries), the media, research centers, and active sponsors of the privatization such as industry analysts. Taxpayers also have a general but diffuse interest in the progress of privatization. Other external stakeholders have a more direct and specific interest in the privatization of the institution: shareholders, borrowers, competitors, and often labor unions usually try to shape the process to their advantage (table 1).

Table 1 Evaluation of a privatized bank: how different stakeholders might weigh their concerns

Stakeholder	*Liquidity policy*	*Credit risk policy*	*Interest and pricing policy*	*Profit-ability policy*	*Capital policy*	*Future economic environ-ment*	*Regul-atory environ-ment*	*Manage-ment strategy*	*Manage-ment controls*	*Evaluation of account-ing*	*Total*
Directors	10	10	10	10	10	10	10	10	10	10	100
Bank supervisors	10	10	10	10	10	10	10	10	10	10	100
Depositors	50	20	5	5	5	5	1	1	1	7	100
Borrowers	5	50	20	5	5	1	15	1	1	1	100
Shareholders (short-term)	5	30	30	2	2	30	1	1	1	1	100
Shareholders (long-term)	5	5	5	50	5	5	5	15	3	2	100
Debt holders	30	10	5	20	20	5	1	1	1	7	100
Employees	1	1	1	15	1	5	5	50	20	1	100

Source: Adapted from Herrick 1978.

Internally, senior managers, middle-level managers, and regular employees have different interests and may rely on different tactics and channels to influence the process. All these stakeholders will want to affect privatization strategies and methods to shape the outcome and the future direction of the institution, its powers, its governance, and, as much as possible, its strategy and business plan.

Choice of privatization methods and bank preparation for privatization. The two main differences between the privatization of a specialized state housing bank and a commercial bank are size and charter. In most emerging markets commercial banks account for the largest share of bank assets. The significance of privatizing a commercial bank will depend on its market share.

The privatization of a housing bank is more ambiguous. On the one hand, the state housing bank is usually a medium-size bank in the financial system, rarely accounting for more than 15 percent of total bank assets.[13] On the other hand, this state housing bank may have a dominant, sometimes monopoly position in the housing market. Thus privatizing a state housing bank will have a major impact on the housing finance system.

Different selling methods, each with its own advantages and disadvantages, can be used in privatizing a state enterprise. Methods include the public offering of shares, the private sale of shares, the sale of the state enterprise's assets to private enterprises, and a management-employee buyout. A public offering of shares is the most likely approach for a bank, especially a specialized housing bank. One reason is that the housing bank, through its dominant position in the housing market, is well known to the public—which should facilitate the share offering.

Once the decision has been made to privatize, many operational decisions need to be made on how to proceed with the public offering and on the extent to which the housing bank must be prepared internally for the offering. On the offering of public shares, typical issues are:

- How many shares will be sold, and what will be the target equity structure?
- In how many stages will shares be sold?
- To whom and under what conditions?
- Under what form of underwriting?
- How should the initial share price be established?
- Under what calendar, and what will determine the specific timing of sales?
- What effect might the stock sale have on the equity market?

On the internal preparation of the housing bank for privatization, several issues will arise that should be reflected in the share prospectus. Restructuring may be needed to offer competitive expected returns to potential investors. In preparing for privatization, several policy and operational issues will likely be encountered:

- Is a change in legal charter necessary? In most cases the initial status of the housing bank under the banking law is that of a specialized bank subject to rules and regulations different from those affecting a private commercial bank. It will be necessary to determinate the impact of a change in charter and conversion to a commercial or universal bank charter.

- Will the bank's balance sheet require significant restructuring prior to privatization? Or can much of the restructuring occur during the early period after privatization? Restructuring will have a major impact on marketability and pricing. The interests of current public shareholders may be significantly affected.[14]

- How sound is the capital structure? Will some strengthening of the capital be required prior to the public offering? Or should the public offering be part of the solution?

- A major issue for current and future social housing policy is the separation of the social mortgage loan portfolio from the commercial mortgage loan portfolio. Why should a private bank continue to be the sole servicer of government social housing programs? If the housing bank loses this privilege, what will be the impact on its earnings and profitability? From a public policy perspective, what will be the new channels for delivery public programs?

- In most countries public banks tend to be overstaffed, even when the economy is not "overbanked" with too many institutions. In such cases, how much bank restructuring is allowed under current labor laws? How much flexibility will the new management have after privatization to raise earnings and profitability by redeploying staff? Will the government provide funding for a fair and equitable severance program if redundancies are required? Who will design that program?

The role and performance of various stakeholders during this first phase are very important. Internal stakeholders—particular senior managers—need to promote and protect the interests of the financial institution and to consider the stock sale as only the first step in privatization. A central outcome of that process is the governance structure that will emerge after privatization.

Among stakeholders, financial authorities used to playing the dominant role—and with an authoritarian style lingering from an earlier era of strong directed credit—may have major adjustments to make. They will need to "listen to the market" and move away from a purely technocratic and possibly self-serving view of privatization. These authorities will need to consider the views of the main stakeholders and reconcile their competing expectations. Failure to do so could lead to costly strategic blunders, delays, and eventually a negative impact on the housing sector in the form of late decisions and a narrower range of strategic options for the bank once it is fully private.[15]

Three Distinct Environments for—and Experiences with—Privatization

As noted, the rationale for privatization is widely shared around the world. But the milestones that mark the process are institution-specific. In between, there are at least three distinct environments for the privatization of financial institutions: OECD economies, economies making the transition from central planning to market, and emerging market economies with small financial systems.

OECD countries: The Spanish case

Bank privatization is not overly demanding in OECD countries. This is particularly the case when state managers have been permitted to pursue profit-oriented commercial objectives and the corporate strategy has been sound. In that case the quality of the balance sheet will not be a major constraint. Because financial markets are deep, selling the stock is essentially a financial and technical issue of selecting the right investment bankers, valuing the shares properly, planning the underwriting, and identifying the right timing.

In Spain financial liberalization started in the 1970s and was associated with economic modernization and opening. The Spanish experience is rich in lessons about what can go wrong when the banking sector is liberalized rapidly without adequate regulation and supervision—and about what can be done to right the situation (Sheng, 1996, ch. 5). Spain also provides a good example of modernization of the housing finance system (Alberdi, 1997).

The privatization of Banco Hipotecario, the state housing bank, cannot be isolated from the liberalization of the financial system or the restructuring of the housing finance system. Banco Hipotecario was created in 1872 along the European model of mortgage banks such as Crédit Foncier de France. It was Spain's only mortgage bank and only issuer of mortgage bonds. The bank was nationalized in 1962 and transformed into a joint stock company in 1971, at the beginning of financial reforms. But Banco Hipotecario's stock remained entirely owned by Instituto de Crédito Official, a government body lending at preferential rates.

Until 1981 Spanish housing finance was highly regulated, segmented, and subjected to regulatory investment ratios. Mortgage finance was essentially monopolized by Banco Hipotecario, which offered fixed-rate mortgage loans. Regional savings banks were also permitted to offer mortgage loans, but under a rigid system of mandatory investment ratios. Commercial banks could offer only short-term loans. There was a shortage of long-term funds, the mortgage bond market was marginal, ratios of mortgage loans to property values were low, and the housing finance system was small. As a result the housing industry was inefficient.

Financial sector reforms took place as part of the opening of the economy and in anticipation of Spain's entry into the European Union in 1986. The reforms had a direct impact on housing finance. Directed credit policies and mandatory lending ratios were abolished. Interest rates were liberalized. Bank licensing and branching were deregulated. Foreign banks were allowed to enter the Spanish market. The mortgage bond market was deregulated, Banco Hipotecario lost its de facto monopoly, and investment ratios were removed from savings banks.

New mortgage finance companies were allowed (Sociedades de Crédito Hipotecario, or SCHs), usually as subsidiaries of commercial banks. Three different mortgage securities were created: mortgage debentures, mortgage bonds collateralized with a specific pool of loans, and mortgage participation certificates secured by a specific mortgage loan. All financial institutions were free to issue mortgage debentures enjoying tax benefits. To strengthen the collateral of these mortgage securities, rules for property valuation were tightened and upgraded.

The 1981 mortgage finance reforms had a very positive impact. Mortgage lending increased significantly, from 13 percent of bank assets in 1986 to 28 percent in 1996. Housing finance deepened from just 8 percent of GDP in 1986 to 19 percent in 1995. Some 400,000 residential mortgages are produced each year for a population of 39 million. Ratios of mortgage loans to property values rose from 50 to 80 percent. Loan maturities increased from 5 to 15-20 years. About 80 percent of loans are made at variable rates. Competition has increased significantly, and foreign banks have stimulated innovations in the market.

But problems remained. Because treasury issues crowded out mortgage securities, mortgage securities continued to play a minor role in funding mortgage loans. Mortgage portfolios remained short-funded (1 percent with mortgage bonds, 5 percent with mortgage debentures, 20 percent through the interbank market, and 74 percent with demand and time deposits). Mortgage participation certificates were not used much because they were administratively complex yet did not free up any capital for the issuer.

The housing finance system underwent further reform in 1991-92 to address funding risks and the asset-liability mismatch. The mortgage debenture market was improved: restrictions on issuers were eliminated, and all financial institutions can tap the market. The market was converted to electronic registration and trading. Maturities were adjusted. On the other hand, fiscal privileges for mortgage debentures were removed.

Mortgage participation certificates were assimilated to an asset sale, freeing capital. These certificates became qualified investments for the technical reserves of institutional investors. Legal and administrative improvements were also made to perfect the registration and execution of mortgage guarantees. A securitization law was passed in 1992.[16] The 1991-92 reforms increased competition and efficiency in the housing finance system, with a significant reduction in spreads.

How did the housing finance reforms and privatization affect the state mortgage bank? Banco Hipotecario was privatized, but not as an independent, heavily specialized lender that would have had trouble managing its risks in a deregulated market. It was privatized after the merger of all public banks to form a new financial group named Banco Hipotecario Argentaria. This group privatized 75 percent of its shares and acts like any other financial group of institutions.

The structure of the Spanish housing finance system has changed dramatically. In 1996 savings banks dominated, with a 53 percent share. Commercial banks, including Banco Hipotecario Argentaria, had a 39 percent share. Mortgage finance companies had just a 3 percent share, and rapidly growing credit cooperatives held a 5 percent share. Banco Hipotecario

Argentaria is still among the six largest lenders that account for 48 percent of the market. But with a market share of 12 percent, it is no longer the largest lender—running a close second to a savings bank.

Banco Hipotecario Argentaria still funds itself with simple mortgage bonds for a normal term of three years. Lacking an extensive retail network, the bank issues bonds on the market at a spread over treasuries. Its funding cost is marginally higher than that of savings banks, which have access to low-cost deposits and issue bonds to their unsophisticated clients at a low spread over these deposits. Mortgage loans are typically made at a variable rate of MIBOR (Madrid Interbank Offered Rate) plus 1.25-2.0 percent. Spanish mortgage rates were falling and in the 1990s dropped below 9 percent. In 1996 inflation was 3.6 percent.

In this fully deregulated market, Spain continues to have a program of subsidized mortgage lending. But these subsidies are separated from finance: interest subsidies and allowances for home buyers are funded in the government budget and targeted to borrowers with specific socioeconomic characteristics. All financial institutions can participate in these social programs. This public policy is designed to minimize distortions in the functioning of the financial market—despite the fact that subsidized lending affects 23 percent of outstanding mortgage debt (Alberdi, 1997).

What effect have mortgage finance reforms had on the development of secondary mortgage markets and capital markets? Funding through the capital market remains small: bonds represent 6 percent of outstanding mortgage loans. This bond market is dominated by savings banks (with a 61 percent market share) and by Banco Hipotecario Argentaria (39 percent share, owing to its monopoly on mortgage bond issues until 1981). The limited role of capital markets is due to the fact that most mortgage lenders still have access to a low-cost deposit base. These lenders are originating variable rate mortgages. Moreover, interest rates have been falling.

Savings banks have been interested in testing securitization, which can free up capital. Since 1993 mortgage-backed securities issues have been made by savings banks, either individually or jointly, and by Banco Hipotecario Argentaria. Securitization has had a significant positive and catalytic effect on the quality of mortgage origination and servicing. Still, the contribution of securitization to funding the market remains small—mortgage-backed securities represent a small fraction of outstanding mortgages. There is little incentive to rely on mortgage-backed securities to raise funds because Spanish financial institutions are well capitalized and liquid and because of the 50 percent risk weighting for mortgages, compared with 100 percent for other consumer loans. Finally, while the mortgage bond market is very liquid, secondary market trading in mortgage-backed securities is infrequent (Alberdi, 1997).

Transition economies of Eastern Europe and the former Soviet Union

The privatization of housing finance in transition economies has to take place in an environment totally different from that in other countries. Here that environment can be described only briefly. Transition economies face the dual problem of privatizing both the housing stock and the financial system. In that environment the financial sector has to be either built from scratch (as in the countries of the former Soviet Union) or rebuilt (as in Central and Eastern Europe).

Central planning left a heavy legacy. Under central planning, true banks—in the sense of financial intermediaries mobilizing resources, guiding the allocation of resources, and monitoring borrowers—did not exist. Rebuilding the core foundations of a sustainable financial system is a prerequisite to developing a commercial housing finance system. In most transition economies the more pressing issue for the housing finance system is how to restructure and privatize the old state savings bank. Under central planning this bank used to be a massive monopoly with a unique branch network that collected the savings of households to fund the state plan.[17]

Emerging market economies

In emerging market economies the structure of the economy and the size of the financial sector often constrain financial liberalization strategies. The smaller is the economy, the greater will be the impact of macroeconomic balance on the modernization of the financial sector. Where the economy is relatively small and the composition of exports is not diversified, trade volatility will affect the financial market and interest rates. The optimal balance between the managerial skills and resources devoted to improving macroeconomic management and those allocated to institutional reforms may be different from that in larger, more diversified economies.

Financial liberalization and privatization require sound macroeconomic policies accompanied by regulatory and supervisory reforms. The need for better regulation and supervision is often overlooked by macroeconomists for lack of familiarity with financial governance issues. Stronger supervision may also be sidestepped by governments because of the often significant political implications of creating strong supervision and bank governance.

Urban laws, policies, and practices play a key role in the wide diversity and uneven development of commercial housing finance in these emerging economies. A basic principle is that bank restructuring will only make sense when it is coupled with restructuring of the real sector. The expansion of commercial housing finance requires clear and enforceable property rights, market-sensitive urban planning, predictable land development codes and practices, and coherent and stable taxation of housing and real estate. Subsidized mortgage loans cannot address the problems of scarce, high-cost housing. Where the housing supply is state driven, the rapid development of private housing finance is significantly impaired.

Housing Finance Strategy: By Design or Default?

As noted, there are important macroeconomic, regulatory, and supervisory preconditions for the successful privatization of commercial banks. Are there also specific preconditions for the privatization of specialized housing banks? In particular, do the authorities responsible for guiding the privatization of the housing finance system need to develop a formal housing finance strategy? No matter what the environment for privatizing a housing bank, two main issues must be addressed:

- First there is the choice of a housing finance strategy. What kind of institutional structure is likely to emerge from financial liberalization, and how is it likely to perform—and be supervised? There is also the technical as well as political issue of how the financing of social housing will fit into liberalized financial markets.

- Second, given the evolving market environment, what will be a sound governance structure for the newly privatized housing bank?

From a housing finance viewpoint, the goal of financial liberalization is to achieve greater participation in mortgage investment by private financial institutions with diversified asset portfolios. With the opening of the economy, a broad-based and resilient system of housing finance is needed to meet the demand for mortgage credit and to allocate risks as efficiently as possible among the institutions best able to bear them. Thus the goal of housing finance reform and privatization is for commercial banks, public and private pension funds, life insurance companies, finance companies, and other major sources of capital to play a far more important role in the housing finance market.

It is not certain that a country needs a highly formalized housing finance strategy with a detailed blueprint. But financial liberalization is a process in which each step must be soundly evaluated. This evaluation may lead to a very formal document, or it may not. What matters is identifying a suitable way of reaching consensus on the desirable shape of the housing finance system and on how to achieve its full integration with the financial system.[18]

How does Korea compare with other OECD countries?

When one compares Korea's housing finance system with those of other OECD countries (table 2), it becomes clear that financial liberalization will induce major changes in the structure and depth of the housing finance system. Several features of Korea's system stand out—and some raise strategic questions.[19]

First, Korea's housing finance system is the most heavily dependent on state-controlled funds. Until government shareholding in the Korea Housing Bank was cut from 96 percent to 47 percent in 1996, Korea essentially had a highly segregated, state-owned housing finance system in which commercial banks and other types of lenders played a small role. At the end of 1995 the Korea Housing Bank held 37 percent of the $50 billion in outstanding mortgage portfolios in the Korean housing finance system—and the National Housing Fund held 49 percent. To avoid negative impacts on the liberalized housing finance system, the future role and management of the National Housing Fund should be given close attention.

Table 2 Structure of housing finance systems in selected OECD countries, circa 1996
(percentage of lending by source)

Country	*Mortgage banks*	*Commercial banks*	*Mutual lenders and others*	*State bank or fund*
Australia	0	88	12	0
Austria	0	32	27	42
Denmark	84	11	5	0
Finland	2	80	6	12
France	18	10	72	0
Germany	12	37	30	21
Ireland	0	67	32	1
Korea, Rep. of [a]	0	41	7	52
Netherlands	22	48	30	0
New Zealand	0	90	10	0
Norway	4	60	13	23
Spain	3	40	58	0
Sweden	85	10	5	0
United Kingdom	0	37	63	0
United States	54	27	18	1

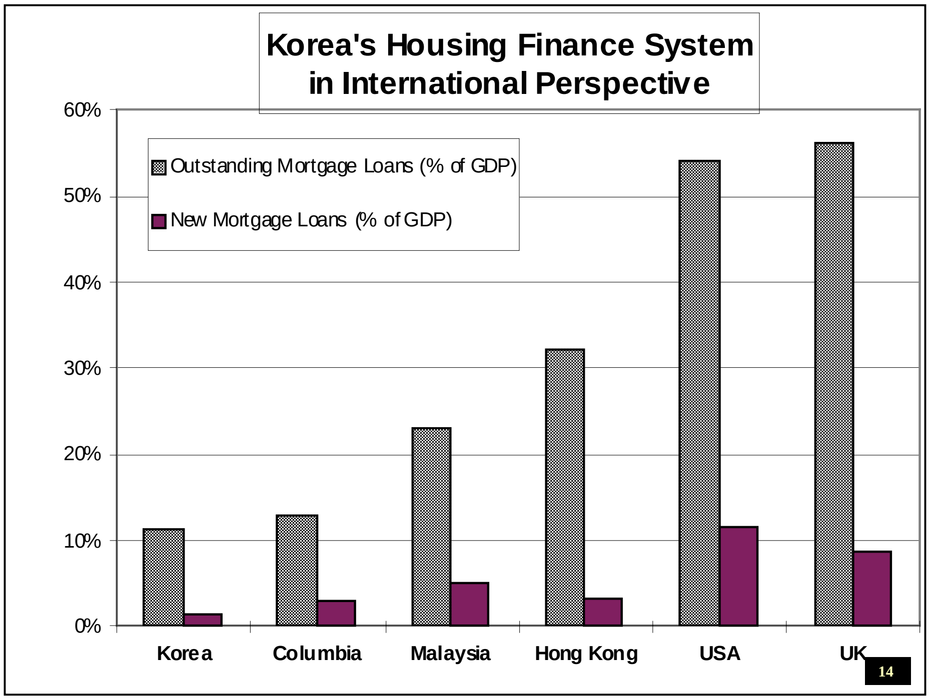
Note: *Mortgage banking* refers to the fact that the originator is funding the loan from capital markets. This category is somewhat misleading because it mixes the activities of closely regulated and long-established European “mortgage banks” with U.S. “mortgage bankers,” who are temporary mortgage lenders. *Mutual lenders and others* refers to lenders like U.K. building societies, U.S. savings and loan institutions, Germany’s Bausparkassen, Spain’s savings banks, and funding mechanisms based on mutual principles such as the French Épargne-Logement. *State bank or fund* refers to financial institutions owned by the state or a variety of national housing funds whose resources are quasi-fiscal in nature and not based on voluntary deposits.

a. In 1996 government shareholding in the Korea Housing Bank fell from 96 percent to 47 percent. In addition, the bank changed from a public specialized bank to a private commercial bank, and changed its name to the Korea Housing and Commercial Bank.

Source: Turner, 1997; *Korea Housing Bank Yearbook 1996*.

Another distinguishing feature of Korea’s housing finance system is that while the Korea Housing and Commercial Bank (the new name of the Korea Housing Bank, changed in 1996) is a substantial bank—with consolidated assets in 1996 of $36.2 billion and a loan portfolio of $22.7 billion—the country’s housing finance system is small by international standards (figure 1). In 1995 the ratio of outstanding mortgages to GNP was just 11 percent, and the ratio of new mortgage loans to GNP was just 1 percent. These ratios are low whether they are compared with those of emerging economies like Colombia and Malaysia or those of advanced financial markets like Hong Kong (China), the United Kingdom, and the United States.

Figure 1

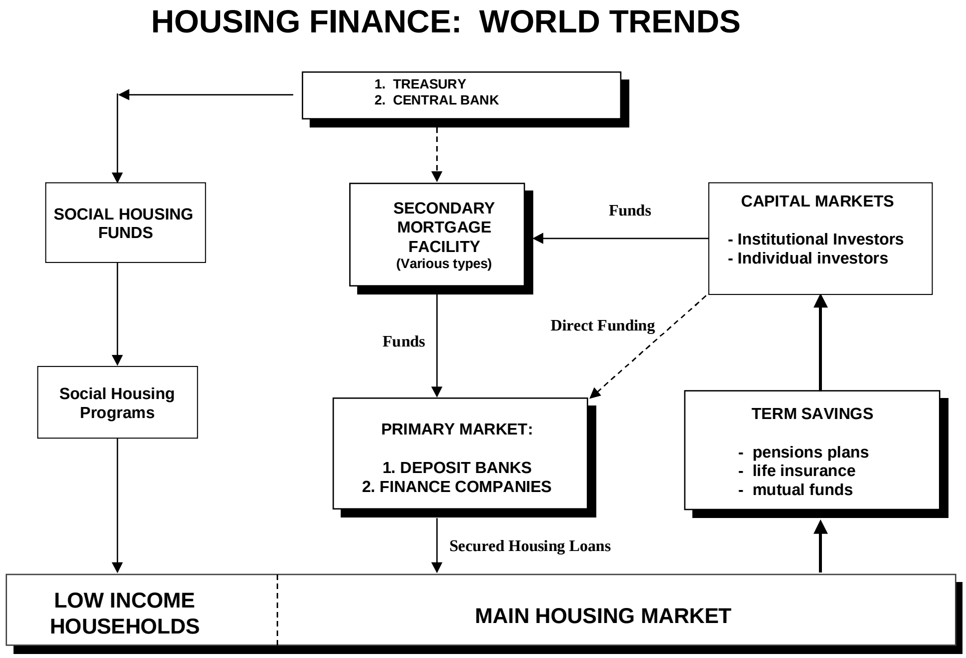


Korea's system and global trends in housing finance

Financial liberalization will have a profound impact on Korea's housing finance system. The process has just started, and there are many options for the future system. Given global trends in housing finance (figure 2), a housing finance strategy for Korea should consider the following issues:

- What variety of primary mortgage lenders should be encouraged?
- How can government policies separate subsidies from finance to permit the development of a private housing finance system? And what new delivery mechanism will emerge for public programs? For what kinds of programs?
- Will credit risks be improved through commercially priced mortgage insurance?
- How will primary market mortgage lenders have access to capital markets? Through secondary mortgage market institutions? Through direct security issues? Through securitization?
- What effect will the growth of contractual savings institutions (pension funds, life insurance companies) and other institutional investors have on the types of mortgages that can be issued by primary mortgage lenders?
- What improvements in Korean fixed-income securities will be needed to develop these links between the housing finance system and capital markets?
- What kind of links will develop with capital markets, as suggested in figure 2?

Figure 2



Source: Renaud, 1996.

Will Privatization Make a Difference?

The ultimate question in privatizing a state housing bank is whether it will make a difference. As international experience shows, privatization is a means to an end—not an end in itself (Roulier, 1997). The end is to build a sound bank capable of functioning effectively and of adapting to a competitive liberalized financial market. Previous sections noted the preconditions for a smooth opening of financial markets and the potential risk of a real asset bubble that could affect commercial banks and specialized housing finance institutions. In addition, when moving from a development banking environment to a market environment, the government plays a critical role in promoting financial sector soundness and good performance through better laws, modern regulation, and effective supervision.

The quality of governance is the overriding issue in building a strong financial institution. Sound laws and good supervision facilitate good governance. Still, a sound bank can exist under an inadequate regulator—but it is impossible for a good bank to exist under a bad system of internal governance (Roulier, 1997).[20] Thus transferring stock to private shareholders is only a tool for improving governance, it is not a goal in itself. Reducing government shareholding in the bank is just an initial step in the process, and complete private ownership is only a prerequisite to a new and sound form of governance.[21] The goal of privatization is to address the problems created by ineffective management under state ownership—a problem that is widespread internationally, as reflected in these easily recognizable findings for Taiwan (China):

- "The complex restrictions from regulations and laws lead to multiple supervision and result in inefficiency.
- The personnel system is inflexible and subordinated to political rewards for service, which results in 'amateur leads expert' and the top managers of [state enterprises] being unable to motivate their workers.
- Appointment to the Board of Directors of [a state enterprise] is an instrument of politically rewarding service. Members of the Board own no stock in the firm. Hence, earning or losing money has no direct impact on them personally.
- The Procedure allows loose financial discipline that leads to blind investment and waste.
- The new investment plans of [state enterprises] often bear various strategic or policy missions, which sometimes are contradictory to the fundamental mission of the firm…and cause difficulty in execution." (Syu, 1995, p. 45)

Syu also notes that "despite these problems, [state enterprises in China] have played a crucial role in its economic development during the last forty years."

Why is governance critical? In a corporation, managers act as the agent for the shareholders who own the institution. But managers do not have the same interests and incentives as shareholders. Thus shareholders elect directors to protect their interests. In a deposit-taking institution, directors are also accountable to bank regulators (and to the deposit insurance fund in financial systems where one exists). These directors are expected to take into account the interest of the various stakeholders in the institution.

The structure of incentives for directors to perform their fiduciary duties well and the board's independence are key issues—and are much more a matter of institutional arrangements than of individuals. It is generally agreed that good governance requires a board composed of a majority of independent directors. The board committee structure should include nominating, audit, and compensation committees consisting entirely of independent directors. Deficiencies within boards of directors contribute to bank problems and bank failures.

The duties of directors are sometimes summarized as the SERVE principle: **S**elect qualified management; **E**stablish business goals, policies, standards, and procedures; **R**eview business performance; **V**oice opinions and questions; and **E**nforce compliance (Federal Home Loan Bank Board of San Francisco 1988).

A bank's board of directors is responsible for establishing the bank's operating practices. In a highly regulated environment and a closed financial system where the government—and eventually the taxpayers—are bearing the risks of ultimate failure, this is not a particularly onerous task. But it is quite difficult in a rapidly changing financial environment. To achieve good governance, directors must be held personally liable for practices deemed unsafe or unsound.

Conclusion

The privatization of a housing finance institution should be prepared from three complementary perspectives: that of the newly privatized housing finance institution, that of the financial sector, and that of the housing sector. The two key ingredients of successful privatization are a sound overall financial strategy for liberalizing the housing finance system and the quality of governance in the newly privatized institution. Government authorities also need a clear understanding of how social programs that were once managed by the public housing bank will be delivered in a privatized environment of decentralized, competing lenders.

Notes

[1] In Asia, however, China faces the rare conundrum of still being a low-income economy, just entering its peak rate of urbanization, and facing a rapidly aging population. The choices it makes for its housing finance system will have a large impact on the economic strength of its cities and its overall development.

[2] In an analysis of the Republic of Korea, Nam (1993) summarizes well the historical factors that led to the state's dominant role in the financial sector in a way that is making liberalization more difficult today. Nam points out that "the overriding objective of tax, credit, interest rate, and trade policies in the 1970s was to promote heavy and chemical industries, including iron and steel, non-ferrous metals, shipbuilding, chemicals and electronics…The government used credit allocation through the banking system as its powerful means of supporting favored industries." These policies were more extreme and less efficient that the Japanese development banking experience, resulting in severe macroeconomic imbalances and a debilitated banking sector. These problems were not addressed until the mid-1980s, when "domestic financial deregulation and trade liberalization were pursued more or less simultaneously as part of a long, still on-going process" (Nam, 1993). See also the comprehensive review of the record of Korean credit policies by Cho and Kim (1994). An important feature of this liberalization was that it bypassed banks in favor of the rapid growth of nonbank financial intermediaries. As a result the ratio of M2 to GNP rose from 0.32 in 1970 to just 0.41 in 1990—while the ratio of M3 to GNP shot up from 0.37 to 1.15. Human resources in the banking sector were weakened as financial skills often migrated to the nonbank financial intermediaries or *chaebols* (business groups). Today, with greater international competition, further government intervention in credit allocation is even more costly to the banking sector than in the past.

[3] Scope economies are typically associated with untapped or unused capacity in the delivery of financial services such as in existing branch networks, in the production of services related to computer capacity, marketing capacity, and borrowing capacity. This combination of scale economies, scope economies, and integrated risk management is an essential feature of financial conglomerates. It differentiates a financial holding from a mere financial mutual fund. In the United States banking subsidiaries do not operate similarly to independent firms; they tend to choose more risky loans and investment strategies and to be less liquid and more highly leveraged. There are also differences between the strategies and structure of group and independent nonbank financial institutions (Benston and others, 1986).

[4] National Commission on Financial Institutions Reform, 1993. The return to the highest savings and loan profitability in a decade has lowered the urgency behind this proposal, which was nonetheless repeated by U.S. Federal Reserve Chairman Alan Greenspan in 1996.

[5] The savings and loan crisis has generated a vast amount of literature. Two useful books are by Lawrence White (1991), who draws the systemic lessons of the debacle, and L. William Seidman (1993), who gives a personal account of his decisions during the resolution of the crisis.

[6] The problems experienced in Scandinavia in the late 1980s have been well documented and extensively studied by the International Monetary Fund, the Bank for International Settlements, and others. See, for instance, some of the analyses by Dornbusch and Park and by Åkerlom in Dornbusch and Park (1995). Finnish analysts popularized the expression "bad luck, bad policy, and bad banking" that is finding such broad use around the world. Finland and Sweden's willingness and ability to confront their problems head-on (instead of hiding them) is leading to a successful restructuring and rapid recovery of their banking systems. The latest illustration of liberalization under weak supervision is Jamaica, where "a collapsing real-estate market and poor supervision of banks and insurance companies have sparked a financial system crisis that threatens economic reforms" (*Wall Street Journal*, 29 April 1997).

[7] In the late 1980s a World Bank review identified 83 countries where privatization had become an major part of the rationalization of state-owned enterprises—and that review took place before the collapse of central planning in the Soviet bloc (Candoy-Sekse, 1988).

[8] In an interesting study, Albert O. Hirschman (1982) explores whether preferences on the public and private provision of goods and services are a consequence of changes in tastes.

[9] The emphasis on the government as regulator does not imply that concerns about market failures have disappeared. Rather, many analysts now think that there are more flexible ways of addressing such failures than through straight state ownership. The eight main sources of market failures are still analyzed in good textbooks on the economics of the public sector: failure of competition, public goods, externalities, incomplete markets, information failures and assymetries, unemployment and inflation, income redistribution, and merit goods (see Stiglitz, 1986).

[10] In the United States government-sponsored agencies such as Fannie Mae and Freddie Mac benefit from several advantages: implicit government guarantees, the ability to issue stock and securities that can be held by federally

regulated agencies (while similar private securities are prohibited), the exemption from Securities and Exchange Commission registration requirements, and regulatory net worth requirements lower than those imposed on comparable private institutions. The role of these privileges is actively debated in the United States. Nobody questions the high level of efficiency or the major contribution of such institutions to the development of the U.S. housing finance system. The issue is the appropriate design of government guarantees and their impact on the competitive structure of the housing finance system. During 1979-93 these government-sponsored agencies grew at a compounded rate of 18 percent, while total assets in the banking system grew at 8 percent.

[11] The damaging impact on the financial sector of rapid asset appreciation and a sharp, destabilizing real estate cycle triggered by poorly managed liberalization policies is a central concern that is now well understood (see Dornbusch and Park, 1995).

[12] Sharp price deflation of real estate assets at the end of a cycle is often a major cause of bank failures. Problems tend to concentrate in commercial real estate portfolios, but they can affect residential mortgage portfolios as well in structurally volatile housing markets such as Finland and the United Kingdom. Real estate asset deflation remains a problem that can be observed in Asia today (*Financial Times*, 21 April 1997, p. 23). See also footnote 6 on Jamaica.

[13] In Korea in 1993, the Korea Housing Bank held 12 percent of bank deposits and 3 percent of demand deposits (*Korea Housing Bank Yearbook 1996*).

[14] There are various ways of removing loan losses from a bank's balance sheet to shield depositors, future borrowers, and future shareholders. This problem is particularly common in transition economies, but it can occur anywhere.

[15] Crédit Foncier de France is the largest and oldest housing finance institution in France, with an 18 percent share of the mortgage market. CFF is a private corporation whose management, however, is appointed by the state. CFF suffered major losses in the aftermath of the recent French real estate bubble. A press review of the slow resolution of this institution points to behavioral problems on the part of financial authorities: "supervisory failures, lack of a strategy on the part of the state, careless drift into the real estate bubble, poor appreciation of public opinion and of the staff's expectations; and a cavalier attitude toward the CFF clients and shareholders" (*Les Échos*, 6 February 1997).

[16] This 1992 Spanish law is unusual because it is restricted to residential mortgages and does not apply to other bank assets. In that sense it can be considered to offer preferential treatment to mortgages: when a broad-based securitization law is passed, commercial banks usually find it more efficient and financially attractive to securitize other assets first before mortgage loans (see Trujillo, 1994).

[17] In three separate papers I have addressed the following questions regarding transition economies. First, what has happened since the collapse of central planning in 1989? In what countries are the necessary and sufficient conditions for the development of market based housing finance systems now in place (Renaud, 1995)? Second, what is a good strategy to develop commercial housing finance in transition economies (Jaffee and Renaud, 1996)? Third, what characterizes the housing finance systems of transition economies relative to other types of housing finance systems around the world (Renaud, 1997)?

[18] At the beginning of the full liberalization of the U.S. housing finance system in 1982, the President's Commission on Housing and its supportive studies played a significant role in mapping out the directions of change, building a consensus, and educating the various stakeholders. A similar process has taken place in a number of European countries.

[19] This paper was written and presented in Korea before the onset and spread of the East Asian crisis in the second half of 1997. Since 1997 Korea has implemented major structural reforms in the real estate sector and in housing finance.

[20] The U.S. banking system is particularly interesting to study because of its large number of institutions operating in a highly competitive environment. In a recent study the U.S. General Accounting Office found that passive or negligent directors were the main contributing factor in 90 percent of the 286 banks that failed in 1990-91 (U.S. GAO, 1994).

[21] The example of Crédit Foncier de France (see above) gives strong evidence that private ownership of the stock is not the issue, but that governance is the key. As noted, CFF is a private institution, but its key officers are government appointees and internal governance was inadequate. This unusual governance structure has not performed well under the rapid liberalization of the financial system reflected in the 1984 Banking Law and high international and domestic financial innovation.

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