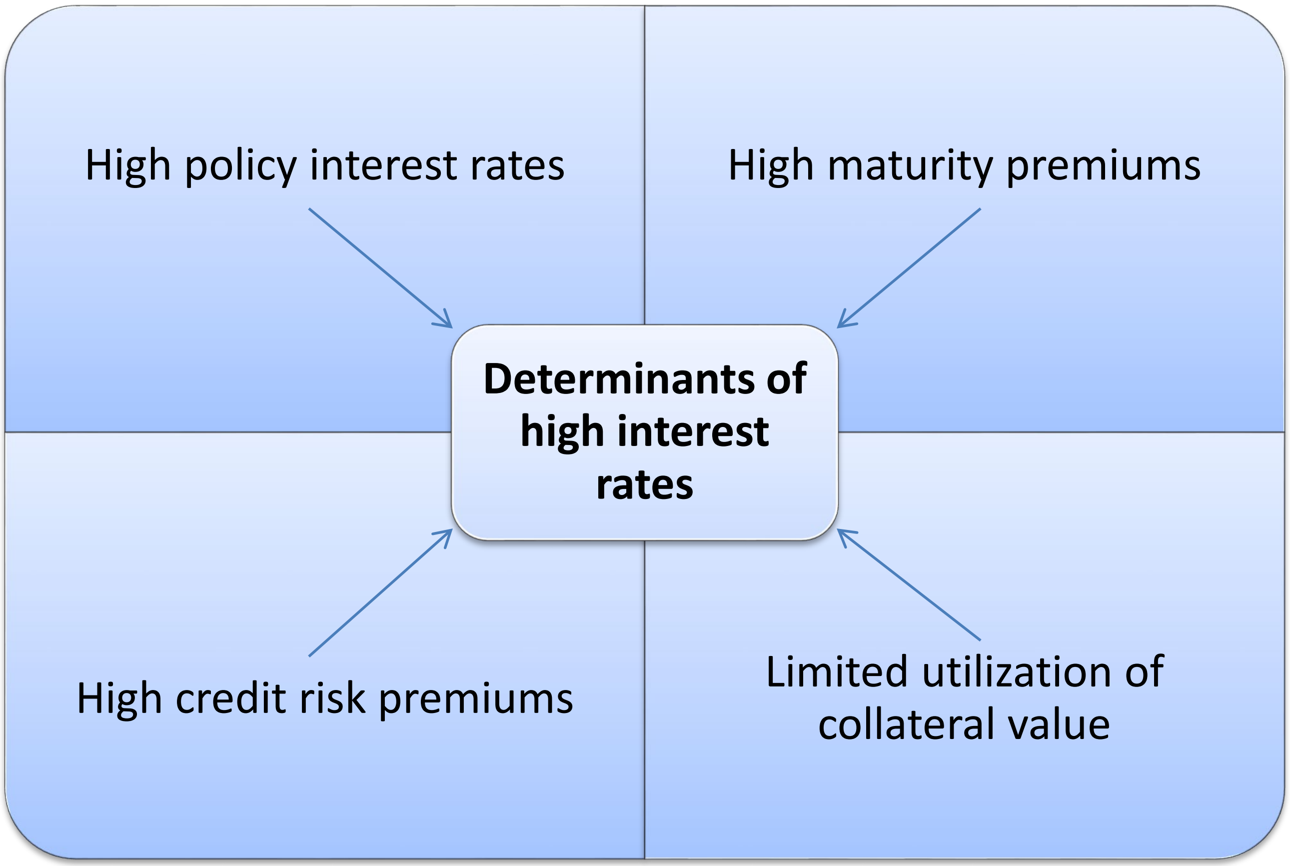
High policy interest rates
High maturity premiums
Determinants of high interest rates
High credit risk premiums
Limited utilization of collateral value

# Channels determining high interest rates

## High policy interest rates

1. Volatile “risk-free” Government borrowing rate

2. Limited confidence in the authorities’ commitment to maintaining macroeconomic stability

3. Fiscal dominance due to:

- narrow tax base and over-reliance on commodity exports as a source of fiscal revenues
- high Government borrowing required to finance domestic investments

## High maturity premiums

1. Mismatch between long-term borrowing needs and available short-term funding

2. Shallow and illiquid domestic financial markets.

3. Absence of liquid government security yield-curve to be used as benchmark for debt funding

4. Institutional investors are absent from investment in the mortgage sector

## High credit risk premiums

1. Small size and fragmentation of financial systems reduces benefits associated with economies of scale

2. High overheads costs associated with high operational and regulatory costs

3. Dominance of large banks, and limited competition and internal inefficiencies

4. Limited innovation and lack of familiarity with mortgage markets due to factors such as crowding out by government borrowing and unavailability of reliable credit information

## Limited utilization of collateral value

1. High risk premiums reflecting assessment of operating environment specific to different countries, regions and even localities

2. The cost and time taken in registration and conveyance of titles.

3. Weak contractual frameworks, and weak legal recourse in realizing collateral value in case of borrower default

4. Lack of familiarity and untested markets for the resale of collateral

# Recommendations and their likely impact

## Reducing policy interest rates

A. Strengthen macroeconomic management and reduce Government borrowing

*Impact*: Uncertain due to policy challenges

B. Place greater reliance on Government borrowing abroad to reduce crowding

*Impact*: Could be beneficial in short-term, but likely to further increase Government indebtedness

C. Direct interventions to control bank lending rates or spread between bank deposit and lending rates

*Impact*: Controls lead to reduced credit provision and reduced competition

D. Interest rate subsidies

*Impact*: Fiscally costly, inefficient, difficult to administer on a targeted basis

## Lowering maturity premiums

A. Increase the availability of long-term funding through mortgage liquidity facilities

*Impact*: Significant, particularly in terms of incentivizing bank lending for housing

B. Introduce a market for covered bonds

*Impact*: Potentially significant, but depends on prior institutional reforms (see below)

C. Develop a sound benchmark Government security yield –curve

*Impact*: Fundamental to the pricing of long-term funding

D. Encourage investment by institutional investors

*Impact*: Significant, but dependent on pension reforms and availability of investment vehicles that diversify risk (e.g. bonds issued by liquidity facility or covered bonds)

## Lowering credit risk premiums

A. Strengthening banking supervision, implementing timely corrective actions and where needed bank resolution

*Impact*: Marked reduction of bank spreads and increased competition that encourages sustainable financial deepening

B. Enhance deposit insurance coverage

*Impact*: Strengthened competition through more level playing field among banks

C. Strengthening sharing of credit information

*Impact*: Significant contribution to reducing bank lending premiums

## Leveraging utilization of collateral value

A. Strengthen property and collateral registration, foreclosure mechanisms, and credit information-sharing

*Impact*: Significant but medium term

B. Use incentives, such as installment sales and partial credit guarantees, to encourage innovation in bank mortgage lending

*Impact:* Encouraging innovation to enter frontier markets

C. Improve affordability through innovative mortgage instrument design: adjustable interest rates, foreign currency or using index-linked borrowing

*Impact*: Exposes borrower to risks (of higher interest rates, currency devaluation and price-index uncertainty)