The effectiveness of the French credit system faced with the challenge of budgetary restrictions

By Bernard Vorms

1. A diversity of tenure

In France, 57.8% of households are owners of their primary residence; 42.2% of households are tenants; 44% of which are in social housing and 56% are in the private rental sector. 32% of homeowners are still mortgagors. 80% of homeowners have single family houses, while 74% of tenants live in blocks of flats.

Institutional investors have left the rented housing sector, 95% of the stock of private rented housing is in the hands of private individuals, the majority of whom own less than three dwellings. Most rented accommodation is in condominiums.

For nearly thirty years, every Government has encouraged home ownership while at the same time supporting the building of social housing, and investment in the private rental sector. In this respect the difference between right and left is chiefly about electioneering: the right parties proclaim their will for France to be a nation of homeowners and the left simply want to allow those who aspire to it to become so, but in reality, political support for home ownership, has been very constant in its ways and means. The increase in the proportion of home owners has been steady, and there has not been the rapid increases seen in the countries like the UK, or to a lesser extent the Netherlands, where social rented properties have been sold to their tenants. The last crisis didn’t lead to a decrease in the proportion of homeowners.

In addition the residential mortgage debt to GDP ratio is very low in relation to comparable European countries even if it has increased steadily over the last years. The rate of debt of the average borrower has increased each year since 2007 (from 29.7% to 31.3%). However, if the French public debt is significant, household debt remains very reasonable.

Nevertheless, in 2008, the subprime crisis resulted in a sharp drop in the number of transactions and construction projects. At that time the French economy underwent its most severe recession since the war, the availability of money for house building contracted sharply (-2.4% in 2009 after +4.3% in 2008), to settle at 430.7 billion Euros in 2009. This decrease was due to the historic drop in activity in the real estate sector, which returned to a level close to that of 2004 (-18.4% in 2009 after -3.1% in 2008). The collapse of investment impacted the purchase of newly built as well of existing properties.

This crisis has not resulted in a credit crunch. The lenders did not ration their supply of credit, although they were accused of this; it is demand which was reduced. Some first time home owners withdrew from the market because they were frightened of the consequences of the economic crisis, while forecasts of lower prices encouraged others to wait and see. As for the buyers-sellers the fear of not being able to re-sell and the tightening of the conditions for bridging loans led to a postponement of purchases. Although there was not a generalised credit-crunch except perhaps for a short period, banks made their lending requirements slightly tighter, notably those which concerned the loan to value of bridging loans, but at no time did they change their attitude in response to an increase in risk in relation to current loans. Indeed, the mortgagors were not severely affected; the rates of default and re-possession barely increased.

From the point of view of lenders even the rise in unemployment has had no significant effect on repayments. It is without doubt in part because unemployment in the first instance affects the young and those with precarious jobs, who are more often tenants. Divorce and separation remain by far and away the principle reasons

Table 1: Residential mortgage debt to GDP ratio, %

<table>
<thead>
<tr>
<th>Year</th>
<th>France</th>
<th>Royaume uni</th>
<th>Espagne</th>
<th>USA</th>
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<tr>
<td>1999</td>
<td>20.8</td>
<td>55.1</td>
<td>26.7</td>
<td>63.8</td>
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<td>2000</td>
<td>21.2</td>
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<td>29.9</td>
<td>70.0</td>
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<td>58.0</td>
<td>32.5</td>
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<td>22.7</td>
<td>62.1</td>
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<td>59.0</td>
</tr>
<tr>
<td>2003</td>
<td>24.3</td>
<td>67.4</td>
<td>40.0</td>
<td>56.4</td>
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<td>71.2</td>
<td>45.7</td>
<td>67.2</td>
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<tr>
<td>2005</td>
<td>29.3</td>
<td>77.5</td>
<td>52.3</td>
<td>88.9</td>
</tr>
<tr>
<td>2006</td>
<td>32.1</td>
<td>82.2</td>
<td>58.1</td>
<td>83.3</td>
</tr>
<tr>
<td>2007</td>
<td>36.7</td>
<td>80.4</td>
<td>62.0</td>
<td>86.5</td>
</tr>
<tr>
<td>2008</td>
<td>39.0</td>
<td>87.7</td>
<td>64.4</td>
<td>82.4</td>
</tr>
<tr>
<td>2009</td>
<td>41.2</td>
<td>85.0</td>
<td>64.0</td>
<td>76.5</td>
</tr>
</tbody>
</table>

1 Source MEDDTL Comptes du logement mars 2011
2 Source SGACP/Autorité de Contrôle Prudentiel
3 Source EMF HYPOSTAT 2010
4 CGDD: MEDDTL Comptes du logement mars 2011
for borrower default. In spite of a marked increase, compared to the levels of the years 2004-2007, the cost of default remains at a very low level (0.08% of outstanding loans in 2010). The amount of loans classified as in default rose slightly compared to 2009, to 1.29%, but remains low; provisions for non-performing loans have decreased for its part regularly since the peak of 42% reached in 2005 and now stand at 30%. The claims rate remains among the lowest in Europe and “negative equity” is not subject to any overall estimate. To what extent is this situation explained by the characteristics of the French credit system, and how is the housing sector likely to evolve now that budgetary restrictions have led to a reconsideration of the extent of public support for housing?

2. An offer of credit to financially stable households

In France, the terms of credit are quite favourable to those who borrow money to buy a house. Competition between the institutions is fierce; so that rates are lower than most of our neighbours, except Germany. They are quite “egalitarian”, because at any given time, the loan conditions are not linked to the income of the customers. In short, the default rate is low and foreclosures are exceptional. But some consider that the downside of this satisfactory situation is the overly restrictive nature of the offer. Already, prior to the Crisis, several new mortgage products had been introduced into the market which were intended to diversify the supply of mortgage products, in particular the introduction of reverse mortgages and equity release loans. Just before the Crisis, the author was entrusted by the government with an exploratory report to facilitate access to credit to those currently excluded, principally, people with non-permanent contracts and the elderly who were unable to obtain life insurance linked to the loan agreement. As the report was submitted after the bursting of the subprime bubble, those of its recommendations that involved a change in the law have been set aside.

2.1 A majority of universal banks

Over the last decades the home credit supply has seen market mechanisms replace, by stages, the dedicated financing schemes put in place by the Government at the beginning of the 50’s. These schemes of credit which have for a long time represented the vast majority of the supply have left room for private market banks. Today, the key to the supply of housing finance is held by a small number of powerful networks dominated by so-called universal banks: Crédit Agricole SA, which has absorbed the Crédit Lyonnais; Caisses d’Epargne which has merged with the network of the Banques Populaires to become BPCE; Crédit Mutuel which bought CIC and the BNP which bought another specialised institution (Paribas) and last, Société Générale and La Banque postale. More than 85% of new housing loans are made by universal banks: in 2005 this percentage rose to its highest level of 88%. Moreover, among the “specialised” mortgage lenders, only the Crédit Immobilier de France was, when this paper was written, still independent, as the Crédit Foncier belongs to BPCE.

Social rented housing still has its own dedicated financing schemes. Loans offered by the Caisse des Dépots et Consignations are, largely backed by a regulated savings product, the “Livret A”, the interest of which is tax exempt. This was previously held only by the Caisses d’épargne (saving and loans), including those managed by the Post Office, which became La Banque Postale. The “Livret A”, is now offered by a number of banks, but part of the resources collected are necessarily pooled by the Caisse de Dépots et Consignations, which uses them to finance social housing. This part of the market is not addressed further in this article.

The various stages of the mortgage process are not handled by separate institutions as they can be in the United States, where the process is unbundled between the broker, who sells the credit, the originator, who keeps the relationship with the borrower, the servicer, and the investor, who holds the mortgage-backed securities. While the share of loans brokered by agents and go betweens has increased over the last few years, it still remains very much a minority, probably lower than 20% and the banks never delegate to these intermediaries the authority to grant the loan. The institution that approves the loan, manages it until it is fully amortised and usually holds it on its balance sheet throughout that period. Therefore arrears and defaults have a direct effect on their financial results, except those arising from loans to the lower income first-time homeowners, which are guaranteed by the Fonds de Garantie de l’Accession Sociale, and described below.

2.2 A personal approach to credit

For the universal banks, with savings inflows from individuals, the home loan is largely a means to develop customer loyalty or a means of gaining new customers; banks lend to their customers or to those who will become customers. They require borrowers to pay their income into the bank via direct debit. But, while the lenders in most countries take into account the value of the property as security (to the point where the term mortgage implies both a guarantee and a secured loan) and also the income of the borrower, the French with very few exceptions focus their attention solely on the creditworthiness of the borrower. This is why the lender almost never asks for a valuation, even though it is going to provide the finance: the value of the security is assumed to equal the amount of the transaction or the price of the construction project. Nevertheless, credit files containing positive data do not exist. On the other hand, banks tend to exclude potential borrowers who are not in stable employment or who are not insured against death or disability.

2.3 Credit access and lender security

It is impossible to obtain an accurate picture of the origin of the sources for funding loans. The banks, which have an overwhelmingly predominant market share, have substantial internal resources through deposits, capital market funding (bond issues) and regulated savings schemes, like “épargne-logement”; “Epargne-logement” is a regulated product that benefits from preferential tax concessions. It is a legal requirement that a part of the money collected for this scheme must be used to finance housing loans. In general, although the proportion of the funds collected in the market increases, the use of specific financial products instruments is low: at the end of 2005, outstanding covered bonds totalled 64 billion Euros, bonds issued by the Caisse de refinancement hypothécaire were worth 18 billion Euros and the securitised real

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1. Cf. https://www2.sgfgas.fr/web/guest/presentation-sgfgas1
2. This judgment was made in a study from the Office/Law Firm of Mercer Oliver Wyman before the Crisis.
4. Schemes which combined polling of earmarked resources such as specific dedicated accounts and a dedicated lender.
5. Hors prêts aidés. Source : Banque de France

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estate debt fund was around 10 billion Euros, while the outstanding housing loans to households stood at 498 billion Euros. Securitisation plays a minor role. The development of investment products that characterized housing finance was associated with none of the abuses which, elsewhere, allowed the lender to transfer the debt and to become disinterested in the final repayment of the loan. So, neither the working of the mortgage process, or the nature of loan security allow the lender to cut the link with the borrower until the loan is fully amortised.

2.4 Death and disability insurance

If credit institutions bear the consequences of losses associated with the loans they grant, certain practices allow them to protect themselves from the consequences of what one would call “the risks of life” (death, unemployment…) Thus, no credit is granted without a death and disability insurance policy in respect of the borrower. This is a cause of the restrictive nature of the supply of credit to the elderly. While it is not a legal requirement it is a unanimous requirement of lenders. In case of death of the borrower, the loan is re-paid by the insurance and the lender does not have to worry about pursuing their estate for repayment, which is particularly helpful given that French inheritance law is rather complex. It is also a protection for the beneficiaries of the estate, whether it is a surviving spouse or children, but it is also an important contribution to net banking income, since almost half the insurance premium is returned to the lending institution that manages the insurance policy as a group policy on behalf of the insurer. Recent legislation has aimed to improve competition in the field of death and disability insurance; it forbids the lending institution to make the loan conditional on the take up of their own group policy if the borrower offers a policy from a competitor organisation which has the same guarantees. For all that the pre-existing situation has not significantly changed.

2.5 “La caution”, a French exception

The caution (bond insurance) is an unconditional guarantee given by a specialised financial entity. This specifically French system of Surety reduces risk to the bank. Nearly 60% of all loans are not registered as a mortgage\(^{10}\). The mortgage security is replaced by a guarantee provided by a specialised body. This guarantee is the undertaking, pledged by a third party, the “Caution” to pay the borrower’s debt in case of default. In return for a fee, the “Caution” agrees to pay the bank the amounts owed by the borrower if the latter defaults. It simply has to be shown that the borrower has defaulted for the guarantee to come into force which, at the first request, must be paid by the guarantor. Moreover, if the credit institution wishes, most “caution” companies take charge of the debt recovery process in case of default. The benefit of this guarantee on the mortgage is evident to the lender: it ensures the return of its funds within a short period, and at the same time removes the management of contentious issues. The paper work for obtaining a guarantee is less than for a mortgage and does need the intervention of a notary. The decision to accept or reject an applicant is, in general, very quick. In the case of late payments, the guarantor who has paid the debt takes on all the rights which the creditor had against the debtor. If an amicable solution is not found, the guarantor can put in place a “judicial mortgage”, and use all available ways of enforcement. The “Caution” companies also differ in their status: some are credit institutions, others are insurance companies. Finally, the cost of the guarantee is determined so as to be less than that of a mortgage deed and it is a very profitable activity which feeds into net banking profits, since most of the mutual guarantee companies belong to banks.

A quick examination would lead one to believe that there is a similarity between the “Caution” and private mortgage insurance in America and mortgage indemnity insurance in the United Kingdom. These are arranged to cover the part of the loan that exceeds the value guaranteed by the mortgage. By transferring part of the risk to the insurer, irrespective of their terms these types of insurance are designed to allow access to credit for borrowers with very little down payment. However, these insurance policies are different from the “Caution” in three essential respects. Firstly, in legal terms, these insurances are complementary to the mortgage which is still required in all cases, whereas the “Caution” is an alternative to a mortgage deed. Secondly, the “Caution” guarantees all of the debt. Thirdly, in terms of function, mortgage protection insurance is required when the percentage of the loan to value is higher than a certain percentage, 70 or 80%; on the contrary the “Caution” insures those cases with the least risk, especially those with a low loan to value ratio. However, the dominance of the “Caution” in the French system could be jeopardised if the project of the European capital requirements directive n°4 is enforced without any change since it does not take in account this kind of guarantee.

2.6 The guarantee fund for social home ownership\(^{11}\)

At the other end of the risk spectrum is the public “guarantee fund” for low income home ownership which is used to reduce the risk for the lender. When the state in 1995 was preparing to remove dedicated financing schemes, it wanted a reassurance that low income first time home owners would not be excluded by a too selective credit policy being applied by some banks and the ability to obtain an offer of credit on conditions similar to those with higher incomes. It is from this perspective that the Guarantee Fund for Social Ownership was established. It guarantees the risk for the lender without taking responsibility to manage their risk. It also helps lower the mortgage rates offered to modest borrowers in two ways: on the one hand, by compensating part of the costs of default, and on the other by inducing an economy of equity capital thanks to the guarantee given by the Government in case of depletion of the fund. Thus it keeps down costs for the lenders allowing it to give almost the same interest rate to low-income and affluent borrowers. The guarantee plays in case of borrower default, to compensate for all losses defined as a decrease in the actuarial rate of return expected by the credit institution granting the loan, taking into account ancillary expenses incurred in relation to the debtor. Finally, it is a guarantee of last resort, which, in principle, is used only when all other guarantees or sureties have been used. The fund requires that the loans which it guarantees are secured by a mortgage guarantee. At its inception, the fund was funded equally by contributions from credit institutions and the Government. In 2005, the very low level of claims since the establishment of the Fund led the government to recover money that had been accumulated in the scheme. The scheme has remained the same, but the fund was replaced with a direct guarantee given by public authorities.

2.7 Consumer protection and information

A final aspect that must not be neglected seeks a fair working of the housing finance sector.

\(^{10}\) Surety from Lending Institutions or Insurance Company Guarantees accounted for 59% of housing loans taken out by individuals in 2010. (Source SGACP/Autorité de Contrôle Prudentiel).

\(^{11}\) Source : SGACP, Autorité de Contrôle Prudentiel.
France has very strong and effective regulation in relation to the provision of consumer information and protection, particularly as regards the borrower. This attitude is reinforced by the strict approach that judges and the legal framework have in relation to lending to individuals. This should be seen as a reflection of the emphasis that French society places on responsible lending, and indeed an attitude of mistrust in respect of credit.

What are the key elements to this?

The law on usury forbids a lender to deviate by more than one third of the average rate of interest charged for loans of a similar nature, which, in times of low interest rates, represents a very narrow margin, e.g. 1.33% when rates are 4% against 3.33% when they rise to 10%. From the perspective of the institutions who would like to focus on non-conforming customers, who represent a higher risk, or involve higher underwriting costs, the current regulations in relation to low interest rates constitutes a major obstacle. While the methods of fixing the usury rate are criticised, in that it increasingly restricts access to credit while the rates are low, the legal principle of a cap to the rate is not questioned by anybody in France. However, these provisions, in the low interest rates conditions which have characterised the last decade, make it impossible to price an increased risk too much above the average rate. If somebody had wanted to sell “subprime” in France, and some institutions were tempted to do this, the relative inflexibility in the interest rates would have prevented it.

Equity withdrawal is not practiced. Indeed, in order to limit the risks, the law that introduced equity release in France banned revaluation of the security being amortised. Therefore, it is impossible to benefit from rising house prices by borrowing against the capital growth; this is one of the major dangers of mortgage equity withdrawal, which at the same time is also one of its main attractions.

While amortised loans at fixed rates account for the vast majority of the loans made, more than 87% in 201012, the law puts a ceiling on the compensation for early repayment of a fixed loan at 3% of the outstanding debt or six months interest. In the case of occupational mobility or of death, no prepayment penalty can be demanded.

Finally, in all the French departments, the Ministry of Housing manages, in partnership with local authorities, housing professionals and associations, “ADIL/agences départementales d’information sur le logement”13, housing counselling agencies, whose job it is to offer free impartial advice to the public on all housing issues. Those considering buying a house can explore their individual purchase and financing plans with an independent specialist, who has links with banks and other professionals. It is important to note that these advisors have absolutely no intermediary or brokerage role.

2.8 A halt to the progress of the integration of the European mortgage markets?

Many of the features described above that explain the fact that French borrowers went through the crisis relatively undamaged were, prior to the crisis, seen as obstacles to the creation of an integrated European mortgage market14. Examples mentioned include “the restrictions on interest rates as the rules prevent usury, the compulsory ceilings for variable interest rates, the proposed ban on interest accrued, etc.) practiced by some countries which may hinder the movement of certain goods and services from one country to another”15. It is doubtful whether following the subprime crisis France is more likely to give up its very high level of consumer protection.

3. Following the crisis - the fiscal austerity measures

The way France has weathered the crisis has demonstrated that its housing finance sector is secure. The approach which may be too restrictive was hitherto compensated by the significant public financial involvement that France allocates for housing policy, nearly 2% of GDP, if we add up all kind of supports, budget support, tax subsidies… The largest part, 16 billion euros, or 43% goes in housing benefit, mostly housing benefits paid out to tenants, but investment grants are also very important. Those that can be assigned are distributed 58% to the social rented sector, 34% to owner occupiers and 8% for investment in the private rental sector16. In addition to the objective of growth and improvement to the housing stock, housing policy is one of the main drivers of macroeconomic management that governments have relied on during periods of economic downturn. Supporting employment in the construction sector and maintaining a consistent level of activity are stated objectives of housing policy. France has not experienced a high volatility in the level of activity or price that can be seen in countries like US or UK. In the social rented sector there are long delays between the decision and the impact on employment. Conversely, it is newly built construction, intended for home ownership that is most dynamic because it is predominantly concerned with building single family house. However, the fiscal austerity measures in 2012 may deprive the government of a support tool for the economy which proved very effective in the 2009-2010 stimulus package.

3.1 The stimulus package

The stimulus package introduced in 2009 was based both on support for the construction of social rented housing, tax incentives for investment in the private rented sector, and also very generous subsidies to encourage the construction or the purchase of new housing by low-income households. During 2010, output increased sharply (+5.2%), reaching 165 billion Euros. Of this amount, in 2010, the share of funding for investment in rental property remained at a high level (18%) without any significant change from 200917. Approximately 800,000 transactions of existing homes were recorded in 2010, an increase of almost 25% over the previous year, and a level close to the highest ever recorded in 2005. The marketing of new housing, if somewhat less dynamic, nevertheless experienced an upturn, the number of sales being around 115,000 for the year 2010, almost 10% more than in 200918.

3.2 The austerity budget for 2012

The Finance Act for 2012 includes a significant reduction in aid for housing, mainly for rental investment and home buyers. Tax assistance for private rental investment has been greatly

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12 Source : SGACP/Autorité de Contrôle Prudentiel.
13 http://www.anil.org/
14 Cf. The report published in August 2005 by the London School of Economics for the European Commission (DG Internal market and services) on the costs and advantages of mortgage market integration expresses it clearly enough.
15 Item cf. LCE report
16 Source : Comptes du logement pour 2009
17 Source SGACP/Autorité de Contrôle Prudentiel
18 Source : Chiffres et Statistiques du Commissariat général au Développement durable – no. 220, mai 2011


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reduced and will be removed later this year. From 1988 to 2006, the private rental market has increased by about one million units from 4.6 to 5.7 million homes. This increase is generally attributed to the effects of the fiscal incentives for rental investment; the first came into being in 198510.

As for the zero-interest loan, the PTZ/prêt à taux zéro10, the principal instrument of financial assistance to home buyers, this has radically changed once again, less than a year after its previous reform. The savings expected from this last measure are of 1.8 billion Euros, resulting in 800M€ outlays for 2012, against 2.6 billion Euros in the current configuration in 2011. The income ceiling that gives entitlement to aid, which was abolished in 2011, has been restored, and its existence is no more really disputed. At the same time, the scheme has been limited to new homes only.

The PTZ, replaced by the PTZ+ is a complementary subsidised loan granted, subject to certain income-related conditions, to first-time buyers. It is the primary public aid measure available to encourage access to homeownership. In 2012, the PTZ+ is once again reserved solely for newly built homes. The liveliest debates have been about the geographical targeting of aid. Should we direct financial aid to areas where the housing supply cannot meet demand, or to the less expensive areas where the incentive to buy is the more efficient? It is the latter choice that was made thus choosing to support jobs in the construction industry rather than building in areas where the imbalance between supply and demand is most pronounced.

How many transactions and building operations will be carried out in 2012? We know that in the first quarter of 2011, 75% of PTZ+ have been granted for the purchase of existing homes, and among the transactions financed by new PTZ+, 71% were located in the less stretched, i.e. less expensive areas. However, it is not possible to draw detailed conclusions retrospectively about the proportion of these transactions that would have been set up in the absence of PTZ+, not least because the efficiency of PTZ+ is likely to be much greater for buying a newly constructed home than for buying an existing dwelling. Similarly for new construction this stimulation effect diminishes as prices rise, so with the strength of the market in the areas of highest demand, because subsidising access to credit does not compensate for lack of down-payment; in very expensive areas, assets are more important that income21.

3.3 Towards a tighter supply of credit?

The difficulty is compounded by the fact that these measures come at a time when banks could be driven to restrict credit supply for two reasons: the current liquidity crisis and the directives of the Prudential Control Authority of the French Central Bank.

In contrast to what can be observed in many other countries, it is not an increase in default rate that would prompt banks to raise their prudential requirements, but their difficulty in obtaining enough resources to finance loans. This liquidity crisis in the euro zone comes as the long term refinancing requirements of banks are increasing; the funding of loans is done through the increasing use of market and prudential requirements, known as “Basel 3” covered by the rate reserve requirements.

At the same time the Prudential Control Authority of the French Central Bank directed the lenders to limit the length of loans and to increase their requirement for capital. These rules are intended to contain too rapid growth in outstanding household mortgages. What is at stake, in the eyes of the French Central Bank, is the systemic risk which is demonstrated by an increase in loan volume much greater than the growth in GDP, which would fuel rising house prices. The lowest-income first-time homeowners of 2009 and 2010 took advantage of exceptional conditions: massive public aid, low interest rates, long length loans and no requirement of down-payment. Unless prices fall or there is a takeover by second time buyers there is a danger of a decline in activity.

This would occur when, for several years, the idea of a “housing crisis” and a general housing shortage has been dominating discussions between the representative bodies of the main housing market players and government. Therefore two questions are raised. Can the current structure of the sector maintain production of housing at sufficient levels? At a time when there is a real threat of recession can the housing sector still play its role in supporting economic activity and employment?

10 Cf. Jean Bosvieux Habitat actualité Janvier 2012/Comment empêcher l’érosion du parc locative privé?
11 The PTZ, replaced by the PTZ+ is a complementary loan granted, subject to certain resource-related conditions, to first-time buyers. It is the primary public aid measure available to encourage access to homeownership.
12 In Paris, to take the example of the most expensive market, the price of a new apartment of 80 m2 accounts for over 20 years of household income for the Paris region’s median decile. Buying a new home is only possible if the household makes a very large personal contribution; on the other hand, many first-time buyers in the small low-density areas finance their entire purchase through borrowing.